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CEE REPORT

Bulgarien / Bulgaria
Kroatien / Croatia
Polen / Poland
Rumänien / Romania
Slowakei / Slovakia
Slowenien / Slovenia
Tschechien / Czech Republic
Ukraine / Ukraine
Ungarn / Hungary
Albanien / Albania
Estland / Estonia
Lettland / Latvia
Litauen / Lithuania
Mazedonien / Macedonia
Russland / Russia

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Wirtschaftsprognosen und Analysen für die wichtigsten Länder Zentral- und Osteuropas

Bewegte Zeiten

Turbulent Times

Nach der Aufnahme von 10 neuen Mitgliedern mit 1. Mai 2004 hat die EU beim Gipfel der Staats- und Regierungschefs im Dezember weitreichende Entscheidungen getroffen. So wurden die Beitrittsverhandlungen mit Bulgarien und Rumänien abgeschlossen und der Beitritt mit 1. Jänner 2007 bestätigt. Voraussetzung ist allerdings, dass die vereinbarten Maßnahmen im Bereich der Übernahme der Acquis Communautaire und die Beseitigung von Schwachstellen im Bereich Justiz und Inneres, bei Rumänien darüber hinaus in der Wettbewerbspolitik sowie beim Umweltschutz erfolgt. Die EU-Kommission wird einen jährlichen Bericht vorlegen, in dem die Fortschritte analysiert werden. Bei fehlender Anpassung ist die Verschiebung des Beitritts um ein Jahr möglich. Die Beitrittsverträge sollen im April diesen Jahres unterzeichnet werden.

Die Verhandlungen mit Kroatien sollen am 17. März 2005 beginnen, sofern Kroatien mit dem Kriegsverbrechertribunal in Den Haag zusammenarbeitet. Die EU-Kommission wurde aufgefordert einen Vorschlag für einen Verhandlungsrahmen auf Basis der Erfahrungen der letzten Erweiterungsrunde zu erstellen.

Beschlossen wurde auch, mit der Türkei im Oktober Beitrittsverhandlungen zu beginnen. Diese haben den Beitritt zum Ziel, allerdings ist der Ausgang – wie bei allen Verhandlungen – prinzipiell ungewiss. Für den Fall eines Scheiterns wird über eine spezielle Partnerschaft, die über das bereits geltende Freihandelsabkommen hinausgeht, und der Tatsache eines strategisch/militärischen NATO-Partners gerecht wird, spekuliert.

Fest steht, dass durch jede Erweiterung die Union ihr Gesicht verändert. Wie durch die südlichen Mitgliedsstaaten der Mittelmeerraum zum Thema wurde, so sind durch die Aufnahme der zentral- und osteuropäischen Staaten die Grenzen der Union an Russland, Weißrussland und Ukraine verschoben worden. Dass dies nicht ohne Auswirkung bleibt hat sich sehr rasch mit der Entwicklung der ukrainischen Präsidentschaftswahl gezeigt. Hier ist die Union herausgefordert einerseits ihren immer wieder geäußerten Forderungen nach freien und fairen Wahlen Nachdruck zu verleihen und andererseits – wie in diesem Fall – die Beziehungen zu wichtigen wirtschaftlichen und/oder geopolitischen Ländern nicht zu gefährden.

Die Entwicklung in der Ukraine hat und wird nicht nur im Lande selbst, sondern auf die Region, auch auf die Europäische Union als Ganzes, Auswirkungen haben. Dieser Bedeutung Rechnung tragend wird diesmal auch der Ukraine-Bericht zweiseitig sein.

After accepting 10 new members on 1st May 2004, the EU took far-reaching decisions at the summit meeting of heads of state and government leaders in December. Accession negotiations with Bulgaria and Romania were concluded and the countries' accession to the Union on 1st January 2007 was confirmed. The confirmation is however subject to the implementation of measures for the assumption of the acquis communautaire and the elimination of weaknesses in the areas of justice and home affairs, and, in the case of Romania, also competition policy and environmental protection. The EU Commission will prepare a report each year which analyses the progress made by each country. EU accession may be postponed by one year if a country fails to make the necessary adjustments. The accession treaties are to be signed in April this year.

Negotiations with Croatia are to commence on 17th March 2005, provided Croatia agrees to cooperate with the Hague Tribunal. The EU Commission was requested to prepare a proposal for a negotiation framework based on the experiences in the recent round of enlargement.

The summit participants also agreed to start accession negotiations with Turkey in October. While Turkey's accession to the EU is the ultimate objective, the outcome, as with all negotiations, is uncertain. It is speculated that if negotiations should fail, the EU and Turkey would enter into a special partnership which would exceed the scope of the current free trade agreement and meet the requirements of a strategic/military NATO partner.

It is undisputed that the appearance of the Union changes with each enlargement. Just as the Mediterranean region was a focus of debate on account of the member states in southern Europe, so also have the Union's frontiers with Russia, Belarus and Ukraine been shifted through the accession of the countries in Central and Eastern Europe. From the developments in the presidential elections in Ukraine it was soon clear what implications an enlargement process will have for the EU. The Union is challenged on the one hand to give emphasis to its repeated demands for free and fair elections and, on the other hand, not to jeopardise its relations with countries of economic and/or geopolitical significance.

The developments in Ukraine have repercussions not only for the country itself, but also for the region and for the entire European Union, now and in the future. For this reason, the report on Ukraine this time covers two pages.

The Editors

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Area: 110,912 sq. km
Population: 7.8 mn
President: Georgi Parvanov
Prime Minister: Simeon Sakskoburggotski
GDP (2004): EUR 19.7 bn
Per capita GDP (2004): EUR 2,540

Bulgaria

With dynamic growth into the 2005 election year

Political situation

Following the early completion of accession negotiations with the European Union in June 2004, the EU heads of state and government confirmed at the summit in Brussels on 16–17 December 2004 that Bulgaria was ready for accession. The signing of the accession agreement in April 2005 will constitute the official seal to Bulgaria's EU membership as of 2007. A referendum on the EU membership of the country will in all likelihood take place at the same time as the parliamentary elections at the beginning of June 2005. According to the results of opinion polls, around two-thirds of the population in Bulgaria supports membership of the EU.

At present it looks as if the Bulgarian Socialist Party (BSP) will emerge victorious from the upcoming parliamentary elections. It enjoys the backing of almost one-quarter of the population and thus has a ballot advantage of approximately ten percentage points over the second-placed National Movement Simeon II. However, since none of the parties will be able to achieve a majority in parliament all signs currently point towards a coalition government under the leadership of the BSP. For the time being the number and identity of potential coalition partners is unclear due to the ruptured political landscape as a result of the fragmentation of some parties and the concomitant reorientation of some of these groupings.

Economic situation

With a growth rate of a real 5.8 % the Bulgarian economy continued its outstanding performance in the third quarter of 2004, its momentum falling only marginally over the growth rate of the previous quarter (6.0 %).

On the production side, the good performance of the agricultural sector played a crucial role in the swift momentum of the third quarter as did the high growth of the service sector, driven by the extremely strong tourist season, both of which impacted positively on the labour market. The unemployment rate fell to 11.9 % at the end of November after 13.2 % in November 2003. Over the same period, employment climbed by around 100,000 to 2.16 million – thanks also in part to the continuing boom in industry and to public sector employment programmes.

On the expenditure side, growth was driven to a large extent by gross fixed capital formation, which over the reporting period expanded by 12 %. In contrast, the stagnating growth in real wages coupled with the increasingly restrictive lending regulations of the Bulgarian National Bank (BNB) induced a reduction in the consumption of private households to 4.1 %, following expansion of 5.4 % in the corresponding period of the previous year and 4.3 % in the preceding quarter. Growth was supported even more by foreign trade. Exports of goods and services expanded by an impressive 15.5 % in light of huge gains in productivity (+16.9 %) as well as a strong tourist season and therefore grew faster than imports (+12.5 %) for the first time since the third quarter of 2002, resulting in a positive contribution of net exports to growth.

In the final quarter of 2004, however, the strong demand for imports of raw materials is likely to lead again to a dampening effect of foreign trade, resulting in a slowdown of growth. Investments will maintain their role as the driving force behind growth in the fourth quarter and help Bulgaria achieve real GDP growth of 5.6 % over 2004 as a whole, the highest rate of growth since the beginning of the transition process.

Bulgaria – Selected Indicators

	2001	2002	2003	2004	2005	2006
Change from previous year in %					*Forecast*	
GDP (real)	4.1	4.9	4.3	5.6	5.3	6.0
Industrial output (real)	2.5	4.7	15.3	16.8	11.9	15.2
Gross fixed capital formation (real)	23.3	8.5	13.8	13.5	12.5	13.8
Consumer prices (yearly average)	7.4	5.8	2.3	6.2	4.5	4.0
Unemployment (yearly average)	17.5	17.4	14.3	12.7	12.0	11.5
Budget balance (central government in % of GDP)	–0.9	–0.7	0.0	0.5	–0.5	–0.3
in EUR mn						
Merchandise exports	5,714	6,063	6,663	7,800	8,800	9,700
Merchandise imports	7,493	7,755	8,859	10,600	12,000	13,500
Current account	–1,098	–874	–1,471	–1,350	–1,700	–2,200
Current account (in % of GDP)	–7.2	–5.3	–8.4	–6.8	–7.8	–9.2
FDI (inflow, net)	896	926	1,234	1,500	2,000	2,000
Gross foreign debt (end of period)	11,848	10,769	10,476	12,000	13,500	15,000
Gross foreign debt (in % of GDP)	77.8	65.4	59.8	60.8	62.2	62.7
Import cover (in months)	5.0	6.0	6.3	6.2	6.4	6.6
Average exchange rate: BGN/EUR	1.96	1.96	1.96	1.96	1.96	1.96
Average exchange rate: BGN/USD	2.18	2.08	1.73	1.57	1.40	1.41

Sources: Bank Austria Creditanstalt Economics Department, BNB, NSI

In comparison to 2004 we expect growth to weaken slightly in 2005. While we anticipate a revival in domestic demand, the resultant boost given to growth will be countered by the rise in the external deficit. Besides the continually robust investment activity, private consumption is likely to be boosted by accelerated growth in real wages, the tax reform and various election promises, while public consumption should also shift into a higher gear because of the election year. At the same time, the higher need for imports that goes hand in hand with a revival in domestic demand coupled with the waning of export growth will be reflected in a more adverse impact of net exports on growth. And even inventory investments that made a significant contribution to growth in 2004 are likely to be lower in 2005. As a result, we expect a moderate slowdown in growth in 2005 to 5.3 %.

Tourism: helper in need?

The summer months brought some relief to the current account. Driven primarily by an extremely strong tourist season and consequently a considerably higher surplus in the balance of services compared to the corresponding period the previous year, the current account surplus amounted to 400 mn euro or 7.3 % of GDP in the third quarter (2003 Q3: 3.7 % of GDP). Thanks to the positive result in the third quarter the current account deficit for the entire year in 2004 will narrow to 6.8 % of GDP, from 8.4 % of GDP in 2003. This decline is only likely to be temporary, however, since in 2005 and 2006 the problems relating to the current account look likely to intensify. In terms of imports there are two factors which are of crucial importance here. The need for imports will be heightened by the robust investment activity on the one hand, which benefits amongst other things from the progress made in structural and tax reforms, as well as by the acceleration in private consumption. On the other hand the powerful import demand will strengthen further in the run-up to EU accession in 2007, i.e. especially in the second half of 2006 before the customs regulations of the EU vis-à-vis third countries are adopted in full. Simultaneously, export growth will be dampened by the expiry of the multi-fibre agreement at the end of 2004 and the accompanying rise in competition from abroad. Exports of textiles and clothing represent around one-fifth of Bulgaria's total export volume. But the continued appreciation of the lev against the US dollar is also likely to weaken the high export growth seen at present, as Bulgaria still handles just over 35 % of its foreign trade activity in US dollars. Taking everything into account we anticipate a gradual rise in the current account deficit in 2005 and 2006 to just over 9 % of the GDP.

With regard to financing, the high current account deficit is coupled with a powerful flow of foreign direct investment, which will cover the 2004 deficit in full. Further privatisation projects as well as the greenfield investments benefiting from the investment-friendly economic environment and the upcoming EU accession will ensure sufficient inflows of FDI also in the following years.

Foreign debt rose from 10.5 bn euro at the end of 2003 to 12.3 bn euro at the end of October 2004. But while public foreign debt has fallen significantly in light of the repurchase of Brady bonds in June, private foreign debt (banks, intercompany loans) has expanded considerably. The coming year should paint a similar picture, with the Ministry of Finance planning to buy back Brady bonds totalling 1–1,5 billion US dollars in 2005.

Putting the brakes on credit growth

Inflationary pressure continued to diminish over the closing months of 2004 thanks to an easing of food prices and prices of raw materials. Nevertheless, inflation will average 6.2 % in 2004, after only 2.3 % in 2003. After the restrictive monetary measures taken by the BNB in July and October failed to have any significant impact, the BNB decided to take further action as of 6 December to curb the rapid growth in lending. By introducing a minimum reserve ratio of 8 % for all deposits, regardless of their maturity, as well as tightening the regulations for calculating minimum reserves (banks' cash holdings no longer qualify as minimum reserves) the BNB intends to drain more liquidity from the banking sector. These steps were necessary after the strong growth in lending failed to show any sign of slowing down in the third quarter. At the end of September 2004 credit volume was by 51 % above the level of the previous year, which clearly exceeded the BNB's reference figure of 30 %. The measures taken to curb liquidity are designed to prevent a deterioration of the current account, but also a worsening of the quality of banks' credit portfolios. If the most recent steps should also prove to be inadequate, the BNB will resort to more vigorous measures. In this respect the introduction of liquidity requirements, a further increase of the minimum reserve ratio, or the implementation of credit ceilings are being considered. ■

Outlook

In the run-up to the parliamentary elections in mid 2005 it seems at present that although a change in government is very likely, there should be no deviation from the stability-oriented economic policy pursued thus far. With a rate of 5.6 % Bulgaria will record its highest growth since the beginning of the transition process. High growth rates are anticipated in the coming years as well, even if the revival in domestic demand will exacerbate the imbalance in the composition of growth components. Given the high demand for imports, the current account will remain the Achilles heel of the Bulgarian economy in 2005 and 2006. Following the strong pressure on consumer prices in 2004, Bulgaria will once again move onto a downward inflationary path in 2005. Yet price and tax adjustments prior to EU accession will only enable a slow decline in the rate of inflation. Fiscal policy remains disciplined with a budgeted deficit of 0.5 % of the GDP, despite the fact that 2005 is an election year. Prudent debt management will help to reduce public debt by the end of 2005 to around half the level prescribed by the Maastricht treaty.

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Area: 56,538 sq. km
Population: 4.4 mn
President: Stjepan Mesić
Prime Minister: Ivo Sanader
GDP (2004): EUR 27.2 bn
Per capita GDP (2004): EUR 6,130

Croatia

In anticipation of EU accession negotiations

Political situation

According to the results of the first round of the presidential election, the incumbent President Stjepan Mesić is best placed to win a second term in the second ballot on 16 January 2005.

The other main event in the political arena was the effort to secure a date for commencing the negotiations for EU membership. On 17 December the EU Council announced Croatia would commence EU membership negotiations on 17 March 2005. However, as long as the issue of Croatia's one remaining fugitive from the Hague Tribunal is not resolved, the government can be exposed to increased political pressure from the EU regarding the commencement and continuation of negotiations over membership. Nonetheless, Croatia's progress along the EU accession path in 2004 has been significant.

In the shadow of preparations for EU accession talks, local elections will take place on 17 April. All in all, the beginning of 2005 will be characterised more than before by political events in Croatia.

Economic situation

The economy slowed in 2004 and we forecast a continuation of this trend in the current year. The growth in credit to both households and businesses is slowing as a result of tight monetary policy. As the government has so far failed to cut public spending and with the current account deficit narrowing gradually, the Croatian National Bank is not in a position to ease monetary policy. Tight monetary policy will continue to constrain private sector investment activity and household consumption. This will occur despite rising wages. In the first nine months of the year real net wages increased 3.9 % and with new wage agreements with most of the public sector providing for further wage increases, earnings will grow. Nevertheless, any acceleration in private consumption will mainly depend on credit growth, which is slowing. In the first three quarters of 2004 real household credit growth was 15.6 % compared to 35.6 % in the same period of 2003. In the first nine months of 2004 private consumption grew by 3.9 %, more slowly than in 2003 when private consumption growth was 4.1 %. Retail sales in real terms rose 2.5 % in the year to October 2004, but a look at durable consumer goods components such as motor vehicles, household electrical and non-electrical durable consumer goods sales in nominal terms shows that the situation is not as bright as it may seem. In the first ten months of 2004 motor vehicle sales have fallen 3.3 %. Furniture and non-electrical goods sales are down 4.4 %, while for electrical goods the fall in nominal sales has been 20.2 %.

Investment activity is also slowing, which is logical given the boom seen in the previous couple of years. After two years of double-digit growth, 2004 will see investment activity grow by about 5.5 %. In the first three quarters of 2004 investments grew 5.5 % compared to 17.5 % in the same period in 2003. The construction activity index clearly reflects a drop in activity. While construction activity grew 23.8 % in the first three quarters of 2003, in the first nine months of 2004 it was only 4.3 %. Even though the government plans to increase public sector investment by 500 mn kuna in 2005, less intensive social housing construction, the completion of the majority of reconstruction projects as well as the main motorway infrastructure all point to more moderate investment activity in 2005. In

Croatia – Selected Indicators

	2001	2002	2003	2004	2005	2006
Change from previous year in %					*Forecast*	
GDP (real)	4.4	5.2	4.3	3.7	3.5	4.0
Industrial output (real)	6.0	5.4	4.1	3.3	3.1	3.7
Gross fixed capital formation (real)	9.7	10.1	16.8	5.5	5.0	6.0
Consumer prices (yearly average)	4.9	2.3	1.8	2.0	2.7	2.5
Unemployment (yearly average)	22.3	22.5	19.5	18.9	18.5	18.0
Budget balance (in % of GDP)	–6.4	–5.2	–6.3	–5.8	–4.5	–4.5
in EUR mn						
Merchandise exports	5,311	5,288	5,569	6,400	6,700	7,100
Merchandise imports	9,888	11,259	12,551	13,200	13,700	14,000
Current account	–810	–2,029	–1,841	–1,700	–1,600	–1,500
Current account (in % of GDP)	–3.7	–8.4	–7.2	–6.1	–5.6	–4.9
FDI (inflow, net)	1,743	1,188	1,727	850	1,110	1,290
Gross foreign debt (end of period)	12,630	16,305	20,722	21,900	23,900	25,200
Gross foreign debt (in % of GDP)	57.0	67.6	81.5	80.8	83.5	83.9
Import cover (in months)	5.2	5.4	5.7	4.8	4.7	4.5
Average exchange rate: HRK/EUR	7.47	7.41	7.56	7.50	7.55	7.60
Average exchange rate: HRK/USD	8.34	7.86	6.70	6.05	5.40	5.47

Sources: Bank Austria Creditanstalt Economics Department, CNB, CBS addition, slower import growth also reflects somewhat reduced investment activity.

Slower economic growth supports current account

These trends should not necessarily be viewed as negative. GDP growth will still be relatively strong at 3.5 % this year. More encouragingly, Croatia's merchandise and current account deficits continue to narrow. Exports of merchandise goods have risen 15.5 % in euro terms in the year to October 2004, while import growth has slowed to 7.0 % (from 9.3 % last year). Therefore we expect the 2004 merchandise trade deficit to shrink marginally in euro terms to 7.0 bn, down from 7.1 bn euro in 2003. Since we will see weaker global growth in 2005, it is unlikely merchandise exports will grow as quickly as in 2004. At the same time, we do not see domestic demand accelerating, meaning that import activity should also remain relatively moderate in 2005. Preliminary reservations suggest this year's tourist season will again be good, although the threat of weaker economic growth in the EU and increasing competition from other Mediterranean tourist markets cannot be discounted. On balance we see the encouraging trend of a declining current account deficit continuing in 2005 and forecast a current account deficit of 5.6 % of GDP this year.

Slight increase in inflation

With oil prices expected to be lower this year their impact on inflation should be reduced. Nonetheless, we see inflation rising to an average 2.7 % in 2005. Wage increases and higher oil prices have already been reflected in higher producer prices which should average 3.8 % in 2004 compared to consumer prices of 2.0 %. This will impact on consumer prices in 2005. However, low inflation will continue to be a characteristic of the Croatian economic landscape in 2005. With foreign exchange reserves covering close to five months of imports and a stronger privatisation pipeline in 2005 we also see a continuation of currency stability this year.

Strong pressure to increase spending

In terms of economic policy, the budget remains the main source of risk. The government has not managed to lower spending. Indeed, it has increased spending. Nevertheless, it is forecasting a fall in the budget deficit to 3.7 % of GDP this year, down from the official forecast of 4.5 % for 2004. Most of this reduction in the deficit is based on increased revenue growth, partly due to the official growth forecast of 4.4 %, which we consider to be optimistic. The other risk to the budget is the appetites of various interest groups both within the government and in the opposition. Part of the ruling party is still hopeful of increasing spending this year, while the Pensioner's Party, buoyed by its successes to date, is becoming increasingly entrenched in its views that pension increases are not negotiable. Our own view is that the reduction in the fiscal deficit will be much more gradual than the official forecast. The pace of this reduction will depend on the government's ability to cut current spending.

In recent months a slowing of foreign debt accumulation has become more apparent. Slowing private consumption will support this trend, but if revenues do not match projections the government will not be in a position to avoid increasing public debt, and therefore, to some extent, foreign debt. The government does not plan to access international capital markets this year to refinance maturing bond issues. Rather it will increase borrowing in the domestic market. Its strategy of refinancing external debt on the domestic market will help reduce foreign indebtedness, but only partially. This is because the banks underwriting domestic bond issues cannot do this without resorting to tapping international capital markets. ■

Outlook

Politics rather than economics will be the focus of interest in 1Q 2005. The first quarter of this year will be dominated by preparations for the EU accession negotiations and local elections. As far as economic growth is concerned, this year presents more risks for the Croatian economy than 2004. The main reason is the weaker growth outlook for the US and the EU which presents the biggest challenges for exports; both merchandise exports and services exports such as tourism. We ad here to our view that the current account deficit will narrow over the course of the year because we do not expect import growth to accelerate in an environment of gradually slowing domestic demand. The commencement of EU accession talks is a major positive for Croatia and it will provide a structure for reform initiatives. That said, the implementation of reforms associated with EU accession will be the main test, especially since the positive effects of these reforms are unlikely to become apparent immediately. In addition, the government is likely to find itself under pressure throughout this year to fulfil the expectations of numerous interest groups. This will present the main risk to fiscal policy, and by extension the development of public and foreign debt. Despite these challenges associated with the structural reform agenda, this year will again be characterised by macroeconomic stability, with inflation low and the currency stable against the euro. However, if the potential growth rate is to be increased in the medium-term and macroeconomic stability maintained, reforms will need to be implemented more consistently.

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Manfred Weidmann

Area: 78,866 sq. km
Population: 10.2 mn
President: Vaclav Klaus
Prime Minister: Stanislav Gross
GDP (2004): EUR 84.8 bn
Per capita GDP (2004): EUR 8,290

Czech Republic

Steady growth

Political situation

The regional elections and the elections to the Senate in November were disappointing for the ruling Social Democrats (CSSD), but extremely successful for the opposition liberal right-wing Democratic Citizens Party (ODS). With the exception of southern Moravia, the ODS obtained the relative majority in all regions in the regional elections. In the second round of the elections to the Senate, which was held in 27 of 81 Czech electoral wards, 18 ODS politicians won the elections in their respective electoral wards, while the CSSD was not able to obtain a single seat. In spite of somewhat more favourable survey results in early autumn, the change from Spidla to Gross both as party chairman and as head of government obviously has not caused voter support for the CSSD to rise materially. The November survey results of the CSSD are worse than before. At the same time the population is more and more unsatisfied with the political situation.

Against this background, emerging rumours with regard to the future of the coalition consisting of the CSSD, the KDU-CSL (Christian Democrats) and the US-DEU (Freedom Union) as well as of early new elections are not very surprising. Stanislav Gross rejected such demands made by the opposition “in consideration of the stability of the country”. His coalition partners also expressed their desire that the present cabinet should remain in existence.

There are, however, already signs of an intensification of infighting within the CSSD concerning the future course to be taken by the party. Minister of Labour Zdenek Skromach, at present deputy chairman of the Social Democratic Party (CSSD), will challenge Stanislav Gross for the position of party chairman at the party convention in March. According to Skromach, the CSSD must return to its election programme and distinguish itself as a left-wing party. Unlike Gross, Skromach advocates a social democratic minority government, which would require the support of the Communists (KSCM). The KSCM occupies the second place in the surveys, enjoying the support of about 17 % of the voters (ODS: 34 %, CSSD: about 14 %). In the future, it wants to dissociate itself more distinctly from its past and act more offensively to attract more voters.

At the party conference of the ODS at the beginning of December, Miroslav Topolanek was undisputed as leader of the party. The most recent success is not only a reason for a higher degree of harmony inside the party, but has also given rise to optimism with regard to the goal of the ODS to govern after the parliamentary elections of 2006.

In mid-December, the coalition government succeeded in getting the draft budget of the central government through by a narrow majority of 101:99 votes after the third reading in parliament. Although amendments moved by MPs resulted in a number of structural shifts in the budget bill, the targeted level of the deficit itself has, however, remained unchanged. The draft calls for the central government deficit to be reduced to 83.6 bn Czech koronas (about 2.7 bn euros or approximately 2.9 % of GDP), down from 115 bn Czech koronas (about 3.6 bn euros or 4.2 % of GDP) in 2004. It is, however, expected that the general government deficit – relevant for “Maastricht” – will be reduced a little less and will

Czech Republic – Selected Indicators

	2001	2002	2003	2004	2005	2006
Change from previous year in %					*Forecast*	
GDP (real)	2.6	1.5	3.7	3.6	3.7	3.8
Industrial output (real)	6.8	4.8	5.8	10.0	6.0	6.5
Gross fixed capital formation (real)	5.4	3.4	4.8	9.1	5.5	4.5
Consumer prices (yearly average)	4.7	1.8	0.1	2.8	2.5	2.8
Unemployment (yearly average)	8.5	9.2	9.9	10.3	10.2	10.0
Budget balance (in % of GDP)	–5.9	–6.8	–12.6	–5.2	–4.9	-4.8
in EUR mn						
Merchandise exports	37,267	40,701	43,140	52,190	59,700	66,700
Merchandise imports	40,690	43,014	45,320	53,440	60,000	66,300
Current account	–3,654	–4,426	–4,940	–5,000	–5,100	–5,000
Current account (in % of GDP)	–5.4	–5.6	–6.2	–5.9	–5.6	–5.0
FDI (inflow, net)	6,114	8,791	2,090	3,650	5,900	4,900
Gross foreign debt (end of period)	25,368	25,738	27,600	29,000	30,000	31,500
Gross foreign debt (in % of GDP)	36.7	36.4	38.4	34.2	32.5	31.5
Import cover (in months)	4.1	6.0	5.5	4.4	3.9	3.5
Average exchange rate: CZK/EUR	34.07	30.8	31.8	32.0	31.3	30.8
Average exchange rate: CZK/USD	38.0	32.6	28.1	25.8	22.4	22.1

Sources: Bank Austria Creditanstalt Economics Department, CNB

Bank Austria Creditanstalt

remain at just under 5 % of GDP. Despite a reduction of the deficit, the fact that public sector investments are estimated to decline, while social expenditures will continue to rise. The goverment therefore has fewer possibilities to stimulate economic growth.

Continued strong growth in investments – accelerated export growth

As recently published figures for the third quarter of 2004 and the revisions with regard to the previous quarters show, economic growth in the Czech Republic has been almost balanced so far this year. After GDP growth of 3.5 % in real terms (y-o-y) in the first quarter, economic growth accelerated slightly to 3.9 % in the second quarter and again amounted to 3.6 % in the third quarter. The figures for the respective quarters of last year were revised upward, economic growth thus being steady at about 3.7 % not only in the course of 2004 but also compared with 2003. Overall, these figures largely also confirm our forecast for 2004 as a whole, for which we expect economic growth of 3.6 % as well.

Particularly striking in the third quarter was the continued strong growth in investments, with gross fixed capital formation expanding by 9.7 %, which was not much below the increase of 10.5 % in the second quarter. Private consumption on the other hand grew at a slightly below-average rate (+2 %), and public consumption decreased markedly (–5.5 %).

The structure of growth started to change to a higher contribution of investments already in mid-2003. This also applies to exports, with an additional acceleration being observed since the second quarter of 2004 – approximately simultaneously with EU membership. In the national accounts the increase in exports of goods and services in real terms of about 10 % in the first quarter of 2004 thus more than doubled to a remarkable 26 % in the second quarter and almost 23 % in the third quarter, while import growth lagged behind, amounting to only slightly more than 19 %, for instance, in the third quarter.

The continuation of the economic growth process is not only supported by the foreign trade figures available but also by the industrial output data. In the third quarter, increases in output (y-o-y) ranged between almost 7 % and about 11 %. Industrial output continued to grow in October as well, showing an increase of 8.1 %. A look at the individual industries shows that the strong performance of the industrial sector in recent months is largely attributable to the exceptionally strong growth of the steel industry. The metal sector, with growth rates of over 20 %, heads the list of strong performers, followed by the electrical and electronics industry and vehicle construction (10 %–15 %).

Inflation rate may have peaked

After showing signs of slowing down already in September, inflation, however, accelerated again in October. But the November figures (CPI: 2.9 %, PPI: 8.2 %) may already be an indication that the inflation rate has reached its peak. The price development has not caused the national bank to raise key interest rates. The two weeks repo rate, for instance, has remained at 2.5 % since the end of August. We now anticipate an inflation rate of 2.8 % for 2004 as a whole. The effect of the factors determining the inflation rate so far seems to decline (increase in excise taxes at the beginning of the year, changes in value added tax in May, seasonal factors). But in particular higher world market prices of oil have not had such an impact on the price level as was still feared in early autumn.

Exchange rate developments have had a favourable effect in this respect. The Czech koruna remained stable against the euro (the margin of fluctuation continued to be within the narrow range of 31.4–31.8 CZK/EUR) also in autumn, thus benefiting from the revaluation of the euro against the US dollar. But in December the Czech koruna also showed an upward trend against the euro. The exchange ratio improved further to 30.8 in favour of the Czech koruna in the middle of the month. The currency is basically supported by the favourable development of foreign trade as well as by the continued inflow of foreign direct investments. A prominent recent example is the investment of almost 500 mn euros by Central European Media Enterprises in the private television station TV Nova. ■

Outlook

After the disappointing performance of the Social Democrats at the regional elections and the elections to the Senate in November, the CSSD will again be faced with intensified disputes over the course to be taken by the party till the party conference in March. The ODS on the other hand is increasingly optimistic to be able to govern after the parliamentary elections scheduled for 2006. Economic growth has been balanced so far in 2004. We expect GDP growth to amount to 3.6 % in real terms on an annual average. With investments increasingly contributing to real GDP as well as due to increasing export growth, the composition of growth clearly improved in 2004. For 2005 and 2006 we now assume that economic growth will not accelerate, but it should remain at its present level. In structural terms, foreign demand will continuously play an important role. This is not only supported by the development since EU accession but also by the longer-term impact of foreign direct investments. The opening of the TPCA car factory, for instance, is scheduled for2005. No additional stimulus is to be expected from the components of domestic demand for the time being. Due to Maastricht, fiscal policy is basically restrictive. Private consumption may rise slightly in line with the cyclical trend, while the strong growth in investments may slow down. Little change is to be expected with regard to inflation – at least on the basis of annual averages – as well as with regard to the current account. There are good chances that the trade balance will show a surplus. The current account deficit will increase slightly in absolute terms (but decline in relation to GDP) as a result of higher decreases in the income balance (profit transfers by foreign investors). Constant FDI inflows will continue to largely offset it and strengthen the currency.

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Area: 93,033 sq. km
Population: 10.1 mn
President: Ferenc Mádl
Prime Minister: Ferenc Gyurcsány
GDP (2004): EUR 80.8 bn
Per capita GDP (2004): EUR 8,080

Hungary

Political manoeuvring takes precedence

Political situation

The government led by Ferenc Gyurcsány has been in office for almost three months, during which time the polling results for the Social Democratic party – chaired by the Minister of Culture István Hiller since the party congress in October – have significantly improved, even though the main opposition party Fidesz led by Viktor Orbán is still the preferred option for the electorate. The government also recently emerged strengthened from the referendum initiated by the opposition to approve dual citizenship for native Hungarians living abroad, as the poor turnout by the population ultimately caused the referendum to fail.

With regard to economic policy, besides the debate on the budget the conflict between the government and the central bank concerning a co-ordinated fiscal and monetary policy have dominated proceedings over recent weeks, with the government succeeding in consolidating its position for 2005: the decision of the parliament to amend the act on the central bank has enhanced the influence that the government can exert on monetary policy. This decision raised the number of members in the Monetary Council – the body that sets interest rates – from nine to eleven people (and to 13 by 2007) and also accorded the prime minister the right to nominate five of these members.

Economic situation

The modest weakening of economic growth continued in the third quarter of 2004. Nevertheless, based on GDP growth of 3.7 % in comparison to the previous year, average growth over the first nine months of 2004 is still an impressive 4.1 %. Even the seasonally adjusted GDP growth of 0.9 % in comparison to the previous quarter – which is therefore down only slightly on the previous quarters – demonstrates that the Hungarian economy is still purring away nicely. The driving force remains investments, whose momentum was even boosted in the third quarter. Despite the steady weakening of expansion in corporate lending from 18 % in the second quarter to 14 % year-on-year, gross fixed capital formation in the third quarter rose by 12.7 % over the previous year (second quarter: +10 %). On the one hand companies are now in a position to finance investments from their own cash flows thanks to a string of good results, and on the other hand they are switching to alternative forms of financing owing to the high Hungarian interest rates. The increase in private consumption narrowed year on year in the third quarter to 3 %, down from 3.8 % in the second quarter. The strength of private consumption was dampened in particular by the development of wages. Over the first nine months net wages in the public sector declined to a slight extent in real terms, a sector that accounts for around 30 % of total employment. Although demand for imported consumer goods slowed with the weakening private consumption, at the same time the strong investment activity and the strong forint exchange rate ensured that the demand for goods from abroad remained high. Thus despite the vibrant expansion in exports which almost reached double figures in the third quarter, growth in imports was slightly higher and so the external sector continued to restrain economic growth rates.

According to our projections economic growth for the whole of 2004 stood at 3.9 % with the various components remaining essentially un-

Hungary – Selected Indicators

	2001	2002	2003	2004	2005	2006
Change from previous year in %					Forecast	
GDP (real)	3.8	3.5	2.9	3.9	3.8	4.0
Industrial output (real)	3.6	2.8	6.4	8.3	6.5	7.5
Gross fixed capital formation (real)	5.0	8.0	3.0	11.6	7.0	7.5
Consumer prices (yearly average)	9.2	5.3	4.7	6.8	4.4	3.9
Unemployment (yearly average)	5.7	5.8	5.9	6.0	5.9	5.8
Budget balance (in % of GDP)	–4.7	–9.3	–5.4	–4.7	–4.0	–3.1
in EUR mn						
Merchandise exports	31,346	36,821	38,270	43,200	47,100	53,300
Merchandise imports	33,611	39,024	41,160	45,700	49,400	55,800
Current account	–1,248	–2,771	–6,560	–7,200	–7,000	–6,900
Current account (in % of GDP)	–6.2	–7.1	–9.0	–8.9	–8.3	–8.0
FDI (inflow, net)	810	891	2,320	2,500	2,800	2,500
Gross foreign debt (end of period)	37,568	38,578	46,380	53,900	59,400	64,000
Gross foreign debt (in % of GDP)	64.9	56.6	63.5	66.8	70.7	74.6
Import cover (in months)	3.3	2.8	2.8	2.5	2.5	2.6
Average exchange rate: HUF/EUR	256.7	243.0	253.5	251.8	261.7	276.8
Average exchange rate: HUF/USD	286.5	258.0	224.4	203.1	188.3	199.1

Sources: Bank Austria Creditanstalt Economics Department, NBH, CSO changed. In 2005 the economy is going to lose some of its momentum. Besides private consumption, which will post lower rates of growth due to the modest increase in wages in the public sector of a nominal 6 % and the cautious monetary policy of the central bank, the weakening of investment growth induced amongst others by the restraint of the public sector is going to restrict the expansion of domestic demand in 2005, although it will still remain the driving force. Thanks to the continually powerful growth in exports, the external sector will not dampen growth in 2005 to the same extent as in the previous year. And the chances are good that in 2006 the Hungarian economy will be able to pick up more speed, propped up primarily by domestic demand.

Falling inflation enables further key interest rate cuts

Consumer price inflation fell under 6 % year on year towards the end of 2004. On average for the whole year inflation was estimated to be 6.8 %. This fall is also due to the strong exchange rate of the forint and the declining growth in consumption. Demand is not likely to exert much pressure at all on inflation in 2005 either, especially as wage growth will be restrained too. The effects of the inflation trend which has been declining since the autumn are going to be more tangible in the first months of 2005 given the elimination from the calculation basis of the strong rise in indirect taxes at the beginning of 2004. On average for the whole of 2005 we are expecting an inflation rate of 4.4 %, with this even falling under the 4 % mark in 2006.

Since the falling trend is being facilitated on many fronts and core inflation is also on the decline, the central bank has faith in the sustainability of current developments and expressed this confidence through further reductions in the key interest rate in November and December by 50 basis points, respectively, to 9.5 %. Although the central bank has announced additional cuts in interest rates if inflation develops favourably, 2005 will see a continuation of its essentially restrictive monetary policy. Higher interest rates should continue to bolster the forint and confrontations with the government regarding a satisfactory monetary policy are not yet a thing of the past. However, the governing parties have in the meantime resolved the much-debated amendment of the central bank law, which provides for an expansion of the Monetary Council. As the prime minister is now authorised to nominate five of the members, it is probable that a more emphatic policy of interest rate cuts will be pursued in the future, even if a complete reversal of the prudent monetary policy is not on the cards.

Number juggling facilitates reduction in budget deficit

Stronger interest rate cuts would provide Finance Minister Draskovics with some welcome relief for the budget. After the 2004 deficit – calculated in accordance with the definition of the Maastricht criteria applied thus far – totalled 5.5 % of the GDP by our estimates, the forecast for 2005 predicts a reduction in the deficit down to 4.7 % of the GDP. The decrease will be achieved primarily by switching infrastructure investments in road construction to Public-Private Partnerships (PPP), while changes amongst others in the personal income tax law that have resulted in only two rates of taxation (18 % for income up to 1.5 million forints and 38 % for income in excess of this figure) will cause a shortfall in revenue, meaning that overstepping the deficit target is again a distinct possibility.

In the latest update of the EU convergence programme that ensued in December, the government has fallen in line with the more beneficial procedure already applied by Poland in presenting the budget deficit. Without waiting for the final decision of the EU Council, from now on the payments made to the mandatory private pension fund pillars created during the 1997 pension reform will no longer be booked as budget expenditure, meaning that the budget deficit is now presented as being around one percent lower per year than was previously calculated. Disregarding the effects of the pension reform the planned deficit for 2005 sits at only 3.8 % of the GDP and is to fall to 2.4 % by 2007, below the limit set by the Maastricht criteria. As we think it likely that the EU will accept the Polish and now also the Hungarian line of argument that these pension payments are not actually budgetary expenses impacting on demand, the budget figures displayed in our overview table are from now on adjusted for the effects of the pension reform. ■

Outlook

In Hungary we can assume that the relatively dynamic expansion with growth rates of 4 % will be sustained over the next two years. With order books full to bursting, industry will be able to continue fulfilling its role as the driving force behind the economy. This encouraging progress will be accompanied by falling inflation, which in contrast to the previous year, however, will no longer be supported by the development in the forint exchange rate. The amended central bank law will enable a different composition of members in the Monetary Council, which is likely to lead to an easing of the high interest rate policy, in accordance with the intentions of the government. The gradual decline in interest rates and as a result in the appealing nature of the Hungarian market will in our opinion lead to an adjustment of the forint rate against the euro.
In the medium term a strengthening of economic fundamentals through a reduction in the high twin deficit of the budget and the current account is an absolute necessity. After the experience of recent years, however, there are doubts as to whether the budget deficit can be reduced as planned, especially since the next parliamentary elections are looming in 2006, which is not likely to be beneficial with regard to the spending discipline of the government. Given the strong need for imports and particularly for capital goods the current account deficit which persists at almost 9 % of GDP in 2004, is only going to fall very slowly, despite the continuously encouraging development in exports. As a result the deficit will still burden the Hungarian economy for some time to come, hindering long-term stable development.

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Hans Holzhacker

Area: 312,685 sq. km
Population: 38.6 mn
President: Aleksander Kwasniewski
Prime Minister: Marek Belka
GDP (2004): EUR 193.7 bn
Per capita GDP (2004): EUR 5,020

Poland

Investment activity picks up

Elections: in May, June or in the autumn

Prime Minister Marek Belka would like the new parliamentary elections to take place in May or June 2005, in time to prepare the budget for 2006 without any election-related pressure. Officially, however, the legislative period only ends in the autumn and many MPs, especially from the ruling Left Alliance (SLD), would prefer the autumn as this would give them more time to prepare themselves better for the elections. An early self-dissolution of parliament is therefore uncertain. The polls taken in December give the Citizens' Platform (PO) 26–27 % voter support, Law and Justice (PiS) 16–18 %. A PO-PiS coalition would need, if at all, only a few additional seats for a majority in parliament. While some members of the PiS have reservations over the PO, a coalition of these parties will be the most probable result of the elections.

Growth finally investment-driven

With real GDP increasing by 4.8 % yoy in the third quarter of 2004, the growth of the Polish economy has slowed compared with the first six months: in the first quarter real GDP grew by 6.9 %, in the second quarter by 6.1 %. Adjusted for seasonal factors it, however, accelerated slightly from 0.1 % to 0.8 % over the previous quarter, according to our computations, driven by stronger fixed investment. Year-on-year, this expanded by only 4.1 %, but after being adjusted for seasonal factors it was 1.9 % above the level of the previous quarter. Stockbuilding continued in the 3rd quarter, boosted by the replenishing of primary material and oil reserves. The external position, on the other hand, deteriorated at constant prices, although Poland's balance of foreign trade developed favourably in nominal terms due to a sharp rise in export prices. Notwithstanding weaker export growth, we estimate 4th quarter growth to have amounted to 4.6 % yoy due to robust private consumption and a further upturn in investment activity. We estimate real GDP growth to have amounted to 5.5 % in 2004 as whole.

Motor-vehicle and infrastructure investment moderate

Companies' expenditures on fixed assets climbed by 9.2 % in the first nine months relative to the previous year, after price adjustments (this figure differs from that of the National Accounts due to the exclusion of households and different cut-off dates). Investment activity is picking up in those sectors in which Poland has a relatively strong position on international markets. In nominal terms, spending in fixed assets rose by 10.8 %. Investments in the food industry for example rose a nominal 33 %, in the furniture industry 38 % and in the textiles industry 45 %. Investment activity was also very strong in various segments of the chemicals industry. Investments in the automotive industry, on the other hand, which account for some 5 % of total investment, declined by 21 %. This contrasts with an impressive 57 % expansion in output of this sector in the first ten months of 2004, coupled with a 10.3 % increase in employment. Sooner or later this downturn will most likely be reversed. The automotive industry has plans to expand production capacity, and the sector supplying components to the industry also intends to enlarge its facilities. According to the Polish investment agency, Opel is planning to com-

Poland – Selected Indicators

	2001	2002	2003	2004	2005	2006
Change from previous year in %					*Forecast*	
GDP (real)	1.0	1.4	3.8	5.5	4.3	4.7
Industrial output (real)	–0.1	8.7	8.7	13.4	9.9	10.5
Gross fixed capital formation (real)	–8.8	–6.8	–0.9	5.0	9.0	9.7
Consumer prices (yearly average)	5.5	1.9	0.8	3.5	3.7	3.0
Unemployment (yearly average)	19.4	20.0	20.0	19.6	18.6	17.8
Budget balance (in % of GDP)	–3.5	–3.6	–3.9	–5.4	–4.5	–3.5
in EUR mn						
Merchandise exports	46,542	49,338	53,836	64,935	74,950	82,360
Merchandise imports	55,100	57,039	58,913	69,840	79,240	88,920
Current account	–5,995	–5,404	–4,109	–3,920	–5,240	–7,670
Current account (in % of GDP)	–2.9	–2.7	–2.2	–2.0	–2.4	–3.0
FDI (inflow, net)	6,373	4,371	3,360	3,300	3,490	4,380
Gross foreign debt (end of period)	81,469	81,046	83,705	95,030	98,490	102,410
Gross foreign debt (in % of GDP)	39.9	40.7	45.2	49.1	44.6	40.3
Import cover (in months)	5.5	5.7	5.3	4.2	3.8	3.5
Average exchange rate: PLN/EUR	3.67	3.85	4.40	4.56	4.15	4.30
Average exchange rate: PLN/USD	4.09	4.08	3.89	3.67	2.98	3.09

Sources: Bank Austria Creditanstalt Economics Department, Statistical Office of Poland, National Bank of Poland mence production of the Zafira model in Gliwice (Silesia) in October 2005. The company is hoping to step up total output in Poland from 116,000 cars in 2004 to 140,000 in 2005, and to increase the number of employees from 2000 to 3000.

Investments in "electricity, gas, water" and "transport, storage, telecommunications", at 12 % and 13 %, respectively, of total investments were also weak. But these segments should likewise benefit from the increased application of EU funds in the coming years, although public investments will be limited by the reduction of the budget deficit.

Current account deficit narrowed

Despite the moderate growth of the European economy, Poland's trade deficit has narrowed from 3.8 bn euros in the first nine months of 2003 to 2.9 bn euros in the same period of 2004. The current account deficit fell from 3.4 bn euros to 2.1 bn euros. According to the balance of payments data, exports were, in euro terms, 23 % higher than in the equivalent period of the preceding year, whilst imports were only 19 % above the previous year's level. Although, adjusted for seasonal factors, growth in exports has slowed since the third quarter, we estimate the current account deficit in 2004 to have amounted to not more than 2 % of GDP. It will increase only moderately in 2005 and 2006 as Poland's industry increases its market share on international markets.

The most interesting feature of the financial account in the period under review is the development of portfolio investments. Investments in Polish debt instruments by non-residents jumped from 2.0 bn euros in the first nine months of 2003 to 6.4 bn euros in the same period of 2004. This is explained mainly by the state's high financing requirement and the attractiveness of Polish government bonds for foreign investors. Foreign indebtedness increased by 10.4 bn euros to 94.1 bn euros from the end of 2003 to the end of the third quarter. Of this amount, the foreign debt of the state alone rose by 5.9 bn euros to 40.8 bn euros.

Fiscal tightening in 2005

In 2004, the state finances seem to have developed more favourably than original budget projections due to strong economic growth and high revenues from corporate tax. The general government deficit according to EU criteria (ESA-95) as interpreted by the Polish government was probably below the budgeted 5.7 % of GDP, at 5.4 % of GDP in 2004.

The Sejm approved the 2005 budget at the end of November. The budget calls for central budget revenues of 174.6 bn zloty (18.3 % of GDP), and a deficit of a maximum 35.0 bn zloty (3.7 % of GDP). The general government deficit is projected to amount to 3.9 % of GDP. The projections assume GDP growth of 5.0 %. In our opinion, the government has slightly overestimated the growth rate and revenue for 2005, especially in view of plans to reduce the standard VAT rate from the current level of 22 % (a rate of 19 % or 18 % is being considered). While any tax reductions are to be offset by increases in preferential rates and the abolition of exemptions, it remains to be seen whether this will actually be the case in the election year 2005. Furthermore, the implementation of important reforms such as of the pension insurance for farmers is not assured. According to our projections, the central government deficit is consequently more likely to come to 4.0 % of GDP in 2005 or slightly more, and the general government deficit to 4.5 % of GDP. But even this is a more restrictive fiscal policy than in the years before. Pursuant to the convergence programme that was updated in November 2004, the deficit in 2006 is to fall further to 3.2 % of GDP in 2006, and to 2.2 % of GDP in 2007.

Privatisation proceeds 1.2 % of GDP

On 10th November the state sold 38 % of its share in PKO BP, Poland's largest bank, in an initial public offering. This transaction generated 7.6 bn zloty (1.8 bn euros) in privatisation proceeds. State revenue from the sale of assets consequently rose to 9.7 bn zloty, which is 10 % above the budgeted figure. The state now still maintains a 62 % interest in the company, domestic small investors hold 16 %, domestic institutional investors 13 % and foreign investors 9 %. In 2004, the originally planned 8.8 bn zloty in privatisation revenue are likely to have been exceeded by some 2 billion, so that total privatisation proceeds accounted for 1.2 % of GDP. This will no doubt be welcomed by the state as a contribution toward financing the budget deficit. Public indebtedness will however probably have risen from 45.4 % of GDP at the end of 2003 to about 47 % of GDP at the end of 2004 according to EU criteria. The rise would have been even more pronounced if the recent appreciation of the zloty had not held down the value of the foreign currency debt expressed in zloty. ■

Outlook

While the growth of the Polish economy has slowed somewhat, it will still range between 4 % and 5 % in 2005 and 2006. The budget deficits must, and will be reduced, even if – depending on the political situation – this could take longer than foreseen in the convergence programme. A strong, even if sometimes volatile, zloty and the moderate wage rises so far will keep inflationary pressure relatively low. The statistical base effect will nonetheless probably keep the inflation rate at over 4 % until May 2005. The further development of investment will be decisive. From a Polish perspective, it is very likely that investment could continue to recover on account of companies' high liquidity and the previous low level of investment activity in the last five years, resulting in pent-up demand. The global economy must however assist in this process – not only to enable the Polish economy to maintain its export markets, but on account of the important role now played by the big international companies for the Polish investment process.

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Area: 238,391 sq. km	
Population: 21.7 mn	
President: Traian Basescu	
Prime Minister: Calin Popescu-Tariceanu	
GDP (2004): EUR 56.7 bn	
Per capita GDP (2004): EUR 2,620	

Romania

Surprise, surprise

Political situation

The parliamentary elections and the first round of the presidential elections took place on 28th November 2004. As expected, the alliance of parties comprising the ruling Social Democratic Party (PSD) and the Romanian Humanist Party (PUR) confirmed the results of the polls by winning about 37 % of all votes and thereby also the parliamentary elections. Second came the opposition NPL-PD alliance with almost 32 % of the votes. This alliance had already received substantial support from the electorate at the municipal elections in June 2004. Other parties which successfully jumped the 5 % hurdle were the nationalist Great Romania Party (PRM) which received about 13 % of the votes and the Democratic Alliance of Hungarians in Romania (UDMR) with 6.2 %. At the same time, the candidate of the PSD-PUR alliance, Prime Minister Nastase (40.1 %), and his rival from the PNL-PD, Traian Basescu (33.9 %), qualified for the second ballot of the presidential elections, in which Nastase was generally considered to have the better chance of winning the run-off. However, in a neck-and-neck race, the opposition candidate Basescu surprisingly won the presidential run-off on 12th December with 51.2 % of the votes, wresting from Prime Minister Nastase an almost certain victory.

Basescu has in the meantime charged the prime minister designate of the PNL-PD, Calin Popescu Tariceanu, with the formation of a government. In the course of the coalition negotiations Tariceanu succeeded in winning over not only the UDMR, but also the small PSD election alliance partner PUR. This gives the government coalition led by the PNL-PD a majority in both the Chamber of Deputies (with the support of the representatives of other minority parties) and the Senate.

After being granted the status of a functioning market economy on 6th October Romania completed its accession negotiations with the EU on 8th December 2004. At the EU summit in Brussels on 17th December, the European Council consequently recommended that Romania be accepted into the European Union. The accession treaty is to be signed in April 2005. However, the conclusion of accession negotiations does not represent a warrant for EU membership in 2007. Pursuant to a protective clause, the Council, upon the recommendation of the Commission, can with a qualified majority postpone Romania's accession to the EU by one year if Romania fails to meet its obligations (especially in the areas of competition policy, justice and the fight against corruption) towards the Union in the pre-accession phase.

Romania – Selected Indicators

	2001	2002	2003	2004	2005	2006
Change from previous year in %					*Forecast*	
GDP (real)	5.7	5.0	4.9	8.3	5.2	6.1
Industrial output (real)	8.4	6.0	3.1	4.5	5.0	6.0
Gross fixed capital formation (real)	10.1	8.2	9.2	13.9	14.5	15.2
Consumer prices (yearly average)	34.5	22.5	15.3	11.9	8.8	6.5
Unemployment (yearly average)	9.0	10.2	7.6	6.8	7.3	7.5
Budget balance (in % of GDP)	–3.3	–2.6	–2.3	–1.5	–2.0	–2.0
in EUR mn						
Merchandise exports	12,722	14,675	15,610	19,000	21,000	24,000
Merchandise imports	16,045	17,427	19,570	23,500	26,500	30,500
Current account	–2,488	–1,623	–2,880	–3,400	–4,500	–5,500
Current account (in % of GDP)	–5.5	–3.4	–5.7	–6.0	–6.4	–6.8
FDI (inflow, net)	1,312	1,194	1,590	3,500	3,000	3,000
Gross foreign debt (end of period)	13,768	15,104	16,710	20,500	25,500	30,500
Gross foreign debt (in % of GDP)	30.7	31.2	33.2	36.1	36.5	37.9
Import cover (in months)	2.9	3.5	3.4	4.8	5.6	6.0
Average exchange rate: ROL/EUR	26,027	31,255	37,556	40,381	37,585	36,831
Average exchange rate: ROL/USD	29,061	33,055	33,200	32,507	22,983	26,497

Sources: Bank Austria Creditanstalt Economics Department, NBR, NIS

Economic situation

In the third quarter of 2004 the Romanian economy delivered a remarkable performance with an almost two-digit growth rate which propelled cumulated economic growth from 6.6 % in the first six months to 8.1 % in the first nine months of 2004. This buoyant growth is largely attributable to the favourable development of the agricultural sector, which grew at a rate of 19.7 % in the first nine months and consequently easily surpassed its poor performance in the drought-stricken year 2003 (+3.0 %). In addition, construction expanded at +10 %, but industry and the services sector also grew by 6.2 % (2003: 4.6 %) and 6.0 % (2003: 5.2 %), respectively. Domestic demand continued to be the engine of growth on the demand side. In the first nine months, private consumption expanded by 9.8 % (2003: 7.1 %). Strong rises in

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real wages (+9.1 %) and a gradual improvement in the employment situation whet the appetite of consumers, which was also reflected in a 12.5 % increase in retail sales in the period under review. Gross fixed capital formation jumped to 13.7 % (2003: 9.2 %) following substantial progress in the restructuring and privatisation of state-owned enterprises, higher EU transfers and massive inflows of FDI. Exports expanded by a double-digit figure (+16.2 %) as a result of high productivity gains. But imports grew by 20.2 % in the first nine months of 2004 on account of robust domestic demand, and consequently still much faster than exports.

We expect economic growth to remain strong in the final quarter of 2004, still supported by domestic demand. But the export sector is also likely to provide a significant impetus to growth, pushing economic growth to a real 8,3 % in 2004 as a whole.

Domestic demand will remain the most important growth component also in 2005. While private consumption will weaken slightly, this will be offset by the further expansion of gross fixed capital formation, which will be supported by the greater progress in structural reforms and the FDI boom, but also by the investment grade status which Romania was recently given and the country's membership of the EU as the accession date draws closer. Robust investment activity will however result in an import pull as well, so that net exports are likely to have a stronger dampening effect in 2005. We therefore expect GDP growth of 5.2 % for 2005.

Deterioration of current account

The current account has deteriorated significantly as a result of robust domestic demand. The cumulated current account deficit consequently amounted to 2.28 bn euro or 5.9 % of GDP at the end of September 2004, after 1.65 bn euro or 4.8 % of GDP in the corresponding period of the previous year. The deterioration is explained mostly by a widening of the trade deficit. The government will in 2004 fail to meet the deficit target of 5.5 % of GDP. We forecast a current account deficit of 6.0 % of GDP (2003: 5.7 %).

The deficit will continue to widen in 2005–2006. The root cause will be a rising trade deficit as a result of demand for imported capital goods. In the light of Romania's accession to the EU in 2007, the country is also expected to experience the "accession effect" in the second half of 2006 that also preceded the accession of the new EU member states in 2004. Furthermore, the expiry of the Multi-Fibre Agreement is likely to dampen textile exports in 2005 (at 23 % of total exports, textiles constitute one of Romania's principal export products). The continued strong appreciation of the leu could moreover adversely affect the competitiveness of Romania's exports. Coupled with the unabated robust domestic demand, these factors will cause the current account deficit to rise gradually to almost 7 % of GDP until 2006.

Inflation below 10 %

After rising temporarily in the summer, consumer prices returned to their downward trend in September. In November the inflation rate was 9.9 % year-on-year, the first single-digit inflation rate since the beginning of the transition process.

The easing of inflationary pressure prompted the NBR to lower the policy rate by 75 basis points to 17.0 % on 16th December, the seventh reduction in 2004. The NBR has consequently lowered the policy rate by a total of 425 basis points during 2004. Further reductions of the policy rate are likely to take place above all in the first half of 2005 (i.e. before the partial liberalisation of the capital account) in an effort to close the gap to interest rates abroad, thereby limiting speculative capital in flows.

The disinflation process is supported by the strong leu. The NBR's announcement that it will pursue a more flexible exchange rate policy is likely to lead to a further appreciation of the leu against the US dollar and the euro in light of Romania's recent upgrading by Fitch to Investment Grade, and anticipated massive capital flows. The currency's appreciation will continue to support the downward trend in inflation despite high oil prices and pending administrative tax and price adjustments. A more flexible exchange rate policy should also facilitate the switch to inflation targeting, announced by the NBR for 2005. The beginning of 2005 will probably see renewed inflationary pressure despite a general decline in inflation in that year. Besides an increase in minimum wages from 2.8 mn leu to 3.1 mn leu and wage increases in the public sector, the price increase is mainly attributable to adjustments of energy prices as agreed with the IMF. We nonetheless believe a decline in the inflation rate to an average 8.8 % for 2005 to be realistic. ■

Outlook

In Romania 2004 was a year of surprises. Firstly, the outcome of the presidential elections defied all expectations. The related change in government that took place is however unlikely to result in any significant changes in the stability-oriented economic policy that has been pursued to date. Furthermore, Romania's timely conclusion of the accession negotiations came as a surprise; with nine negotiation chapters still open at the beginning of 2004, there was general scepticism as to whether the government would be able to meet its goal of concluding negotiations with the EU by the end of 2004. Romania also took many by surprise with its economic boom in 2004. Continued good prospects for future growth confirm that this is not merely a cyclical flash in the pan. With the breakthrough made in structural reform, Romania has moreover laid the foundation for an acceleration of the catching-up process. The introduction of a 16 % flat tax as of 1st January 2005 will also make Romania more attractive business-location. On account of the favourable growth prospects, disciplined fiscal policy and EU membership in 2007, Romania was even given its first Investment Grade rating (Fitch). The country will be faced with further major challenges in 2005 despite its achievements to date. On the agenda are important reform measures such as the partial liberalisation of the capital account, the currency reform and further progress in implementing structural reforms.

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Area: 49,034 sq. km
Population: 5.4 mn
President: Ivan Gasparovic
Prime Minister: Mikulas Dzurinda
GDP (2004): EUR 33.0 bn
GDP per capita (2004): EUR 6,140

Slovakia

Attuned to four wheels

Minority government again successful

The attempt of the opposition to remove Minister for Social Affairs Ludovit Kanik (SDKÚ) from office in mid-December was supported by only 66 of the 134 MPs present, with a minimum of 76 votes being required. On December 9th, 82 of the 145 MPs present voted for the government's draft budget for 2005. The ruling parties continue to succeed in securing the majority of votes in the 150-member parliament, although they can rely on the support of only 69 MPs and have also constantly failed to obtain the backing of the majority of potential voters in opinion polls. Elections are, however, only scheduled for 2006, and the government is likely to remain in office till then at least with the tacit support of individual MPs from the opposition.

Somewhat slower growth

Slovakia's GDP growth slowed slightly from 5.4 % year on year in the first quarter of 2004 and 5.5 % in the second quarter to 5.3 % in the third quarter, with the adjustment for seasonal factors also showing a decline in the growth rate over the preceding quarter from 1.5 % in the second quarter to 1.1 %. Private consumption has beyond doubt recovered from the drop following price increases at the beginning of the year and rose by 3.7 % year on year in the third quarter. At a growth rate of 5.5 % year on year, fixed capital formation continued its rapid expansion that has been observed since the second quarter. Public consumption rose by an unspectacular 2.9 %. Stockbuilding also continued in the third quarter, especially in the area of primary materials. The slight decline in growth was caused by a smaller increase in exports. We assume that growth continued to weaken slightly in the fourth quarter and amounted to 4.9 % year on year, resulting in GDP growth of 5.2 % for 2004 as a whole.

Export growth slightly weaker

Customs-based statistics show a decline in export growth in the third quarter, which nonetheless remains strong. Exports only grew by 8 % year on year in euro terms, compared with still 22 % in the second quarter. Seasonally adjusted data also point to a slowdown. The main factor behind this is the flattening rate of growth in car exports, which account for 27 % of overall exports. In the 3rd quarter, exports of means of transport in euro terms were 20 % below the figure of the previous year. Exports of food, however, developed well. Exports of electrical and electronic equipment, transformers, engines and metals also showed a rapid increase. Growth in imports also slowed, after the strong rise in the second quarter due to EU accession (second quarter: 25 %, third quarter: 14 %), but this decline was insufficient to prevent the trade deficit from widening compared to last year. After weak previous months, the number of registrations of new cars in Europe rose again in November. Nevertheless, we change our estimate for Slovakia's current account deficit for 2004 from 2.8 % of GDP in the last CEE Report to 3.1 % of GDP as a result of the relatively weak development in the third quarter.

Tighter fiscal policy as of 2005

In 2004, both tax revenues, above all from corporation tax and income tax, and dividends from state-held assets developed more

Slovakia – Selected Indicators

	2001	2002	2003	2004	2005	2006
FChange from previous year in %					*Forecast*	
GDP (real)	3.3	4.4	4.2	5.2	4.6	4.8
Industrial output (real)	7.6	6.7	5.3	5.1	5.6	6.9
Gross fixed capital formation (real)	13.9	–0.9	–1.2	5.6	9.2	11.5
Consumer prices (yearly average)	7.1	3.8	8.5	7.6	3.2	2.6
Unemployment (yearly average)	18.3	17.8	15.2	14.4	13.1	12.2
Budget balance (in % of GDP)	–6.0	–5.7	–3.7	–3.7	–3.4	–2.9
in EUR mn						
Merchandise exports	14,102	15,184	19,285	22,460	25,490	29,140
Merchandise imports	16,486	17,437	19,848	23,440	27,000	31,260
Current account	–1,960	–2,049	–243	–1,020	–1,370	–1,910
Current account (in % of GDP)	–8.6	–8.2	–0.8	–3.1	–3.7	–4.7
FDI (inflow, net)	1,674	4,069	485	540	1,440	2,190
Gross foreign debt (end of period)	12,612	13,939	16,177	16,380	17,910	19,590
Gross foreign debt (in % of GDP)	55.2	55.7	53.7	49.6	47.9	48.4
Import cover (in months)	2.9	5.6	5.5	5.0	4.8	4.2
Average exchange rate: SKK/EUR	43.2	42.7	41.5	40.1	38.5	38.0
Average exchange rate: SKK/USD	48.3	45.3	36.8	32.2	27.6	27.3

Sources: Bank Austria Creditanstalt Economics Department, National Bank of Slovakia, Statistical Office

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favourably than expected. On the expenditures side, there were higher-than-planned expenditures related to incentives for investments by KIA Motors (site development, motorway construction) and in the field of education, but on the other hand, there were lower-than-budgeted expenditures as utilisation of EU funds started rather slowly, resulting in relatively low co-payments by the state. Thanks to low interest rates, debt servicing has also been cheaper than originally estimated. Several investment projects have been delayed. Accordingly, we expect the central government deficit to be smaller than the budgeted 5.9 % of GDP, amounting to only 5.3 % of GDP. In contrast, the finances of the pension insurance have developed worse than projected. According to our estimates, the general government deficit is likely to be lower by 0.2 % of GDP than planned, amounting to 3.7 % of GDP, little changed from 2003.

As of 2005 and above all afterwards, fiscal policy will be tightened. Based on an assumed GDP growth of 4.7 % in real terms, the budget of 2005 provides for central government revenues of 257.33 bn korona (18.5 % of GDP, compared to an estimated 18.0 % in 2004) and expenditures of 318.85 bn korona (22.9 % of GDP, compared to an estimated 23.3 % in 2004). The deficit is anticipated to amount to 61.5 bn korona (4.4 % of GDP), and the general government deficit is expected to narrow to 3.4 % of GDP (excluding the costs of the pension reform, which are likely to burden the budget of 2005 with another 0.4 % of GDP but do not have an immediate impact on demand). In view of the positive experience made in 2004, it seems realistic that this goal will be attained.

According to the draft of the Ministry of Finance, the general government deficit is to narrow further to only 2.9 % of GDP in 2006 and to 1.9 % of GDP in 2007 (excluding transfers in connection with the pension reform; we assume that the EU will permit this). We expect that at least the goal for 2006 can be attained, which would make it possible to introduce the euro in mid-2008.

Even more car production

According to the Slovak Ministry for Economic Affairs, the German-American company GERTRAG Ford Transmissions plans to invest about 300 mn euros in the establishment of a production plant for gearboxes in the industrial park Kechnec near Košice in Eastern Slovakia. Production is to start at the beginning of 2007. The plant is to be designed for the production of 300,000 gearboxes a year, achieve sales of 300 million euros to 400 million euros annually and employ about 1,000 people. Other suppliers will also be based in Slovakia. The Austrian MIBA, for instance, wants to produce steel plates with about 150 workers in Vráble, and the Portuguese subsidiary of the American Keyplastics wants to manufacture plastic parts with 400–500 workers in Dolný Kubín. Car production more and more also has an impact on other industries: U.S.Steel Košice is considering to invest 200 mn US dollars in a new production line for galvanised sheet iron to supply the Slovak car industry. The decision is expected to be taken at the beginning of 2005.

If Slovakia will reach a manufacturing capacity of 700,000–900,000 cars a year as planned as of 2007, it will produce one car per six or seven inhabitants. By comparison: in 2003, one car per 11 inhabitants was produced in Belgium, the top performer in Europe, in Spain one car per 14 inhabitants, in Germany one car per 15 inhabitants, and in Austria one car per 58 inhabitants. In 2003, the ratio was still 1:19 in Slovakia itself, 1:23 in the Czech Republic, and 1:127 in Poland.

Strong koruna

On December 13th, the Slovak koruna broke the important barrier of 39.0 against the euro. This may among others also be attributable to the development of the ratings for Slovakia: On the same day, Standard and Poor's raised its long-term foreign currency rating from BBB+ to A-. Thus, Slovakia has drawn level with the Czech Republic and Hungary and is one rank better than Poland.

The central bank has repeatedly opposed a too strong appreciation and lowered its 2-week repo rate by 50 basis points to 4 % on November 26th. Although the Slovak koruna weakened for a time, its renewed strengthening could not be prevented. The prospect that the current account may show a surplus as of 2007 as a result of the start of car production in the new plants of Peugeot-Citroen and Kia and that the current account deficit is likely to be more than 100% financed by the inflow of direct investments till then, nevertheless prompts the financial markets to push up the Slovak koruna. ■

Outlook

We expect Slovakia's real GDP growth to be slightly lower in 2005 than in 2004 due to a widening of the foreign trade deficit, increased fiscal restraint and not so strong stockbuilding, but still amount to 4.6 %. Meanwhile, the conditions for a renewed acceleration as from 2007 will be created. Inflation will again drop below 4 % as of 2005. Larger increases in regulated prices or indirect taxes are no longer imminent. As a result of imports of consumer goods being promoted by the strong currency, the current account deficit will widen in 2005, but particularly in 2006, when a large part of the equipment for the new car plants will be imported. Due to simultaneously rising exports, it will, however, probably remain below 5 % of GDP and change into a surplus in 2007. In spite of the deterioration in the current account, we expect real GDP growth to amount to almost 5 % in 2006 thanks to increasing incomes and strong investment activity. Of course you cannot link your fate to the car industry and remain unaffected by possible drawbacks. Therefore, the development of the global car market is the main risk involved in our forecast.

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Area: 20,273 sq. km
Population: 2.0 mn
President: Janez Drnovsek
Prime Minister: Janez Jansa
GDP (2004): EUR 25.9 bn
Per capita GDP (2004): EUR 12,950

Slovenia

Increasing momentum

Political situation

Janez Jansa from the Slovenian Democratic Party (SDS) who won the parliamentary elections in October has headed up a coalition government since the beginning of December as the new prime minister. Besides the SDS this coalition also comprises the conservative New Slovenia Party (NSi) and the Slovenian People's Party (SLS) along with the Democratic Party of Pensioners (DeSUS). The new government enjoys a majority of 49 members in the parliament. The most prominent members of the coalition cabinet are Foreign Minister Dimitrij Rupel, who also filled this position in the previous government led by the Liberal Democrats until the split with Prime Minister Rop in the spring, and Finance Minister Andrej Bajuk. The founder of the NSi was prime minister for a brief period in 2000.

Given the relatively tight majority in the parliament that is only secured by the four seats of the DeSUS, the process of making political decisions could prove to be troublesome in practice. Moreover, the need for agreement within the 4-party coalition that has no experience of government affairs implies the risk that decision-making will be delayed. In terms of foreign policy, however, no major changes are anticipated. At present, priority is being accorded to taking over the presidency of the OSCE in 2005. Looking at domestic affairs the new coalition government is promising a liberal economic policy, which amongst other things could be expressed in its policy on privatisation and in more flexibility on the labour market.

Economic situation

While 2003 was characterised by the weakest growth in GDP in the history of Slovenia as an independent state, in the meantime recovery has been far stronger than originally expected. Economic growth accelerated to 4.9 % year on year in the third quarter of 2004, having climbed to 4.3 % in the first half year in comparison to the same period the previous year. Domestic demand again made a significant contribution to this in the third quarter. Following the temporary weakening in the second quarter, private consumption rebounded with growth of 3.8 % to equal the expansion recorded at the beginning of the year. This was caused by strong increases in wages in the private sector, the clear rise in employment and an acceleration in consumer lending to private households to almost 18 % in the third quarter, following single-digit growth rates throughout 2003. The vigorous economic growth was boosted in particular by investments. Up by 6.3 % year on year in the third quarter, gross fixed capital formation was able for the most part to maintain its momentum of the previous period. The input of domestic demand to growth on the other hand was weaker than in the second quarter. The reason for this can be found in the development of inventory investments. The first half of the year was characterised by strong rises in inventories in connection with EU accession in May 2004, since business owners wanted to avoid potential price increases of imports after accession. These stocks diminished again in the third quarter as was to be expected. The biggest surprise in the third quarter, however, was that for the first time since the fourth quarter of 2002 the external sector once again made a positive contribution to economic growth, accounting for as much as one percent of GDP growth. Thanks to vibrant demand primarily from EU countries, exports expanded

Slovenia – Selected Indicators

	2001	2002	2003	2004	2005	2006
Change from previous year in %					*Forecast*	
GDP (real)	2.7	3.4	2.5	4.2	3.8	4.0
Industrial output (real)	2.9	2.4	1.4	4.8	4.0	4.5
Gross fixed capital formation (real)	–0.4	1.3	5.5	6.8	6.0	5.0
Consumer prices (yearly average)	8.4	7.5	5.6	3.6	2.9	2.8
Unemployment (yearly average)	6.5	6.3	6.7	6.4	6.2	6.1
Budget balance (in % of GDP)	–2.7	–1.9	–1.8	–2.3	–2.1	–1.8
in EUR mn						
Merchandise exports	10,454	11,081	11,427	12,550	13,400	14,500
Merchandise imports	11,139	11,347	11,971	13,300	14,300	15,450
Current account	38	330	17	–70	–120	–150
Current account (in % of GDP)	0.2	1.7	0.1	–0.3	–0.4	–0.5
FDI (inflow, net)	251	1,582	–115	100	300	300
Gross foreign debt (end of period)	10,403	11,482	12,995	15,200	16,500	17,500
Gross foreign debt (in % of GDP)	47.5	48.9	52.8	58.6	59.4	59.0
Import cover (in months)	4.6	6.7	5.9	5.1	4.8	5.1
Average exchange rate: SIT/EUR	217.2	226.2	233.7	238.9	238.8	238.5
Average exchange rate: SIT/USD	243.3	242.7	207.1	192.9	171.5	171.6

Sources: Bank Austria Creditanstalt Economics Department, SNB, SORS

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in real terms by almost 12 % compared to the previous year, while import growth diminished to 10 %.

This development looks to have inverted again towards the end of 2004, thus leading to slower economic growth in the fourth quarter. Nevertheless, following the GDP growth of 4.5 % posted in the first nine months we estimate that economic growth throughout 2004 will rise to 4.2 %, its highest level for five years.

Positive trend on the labour market

The positive effects of the lively economic development have in the meantime spilled over onto the labour market. Employment rose by more than half a percentage point in 2004 and the number of people registered as unemployed fell by nearly 5 %; the unemployment rate in accordance with the ILO definition has fallen to 6.4 % (2003: 6.7 %). Over the next two years we can expect further improvement on the labour market, especially since general economic prospects for 2005 and 2006 continue to be upbeat. We anticipate growth in 2005 to be only slightly weaker than in the previous year. GDP growth of just under 4 % will continue to be bolstered primarily by domestic demand. Although both private consumption and investments will lose some of their momentum, they will still provide a healthy boost. Private consumption will profit from growth in real wages, which is expected to amount to more than 2 %, as well as the clear fall in interest rates on consumer loans. The lower interest rates will also encourage companies to invest more. By contrast we hardly anticipate any assistance from the external sector in 2005. While the persistently strong demand for consumer and capital goods is strengthening import demand, export growth will be lower than in the previous year. Only in 2006 will foreign demand again be able to provide stronger support for the Slovenian economy. Backed by improved economic outlooks in the "old" EU member states, economic growth in Slovenia that is still based on the fairly robust domestic demand will again be able to pick up.

Falling inflation

This encouraging picture painted of economic trends is accompanied by falling inflation. Recorded at 5.6 % in 2003, inflation over the last twelve months sank to 3.6 % on average for the year, despite strong surges in the prices of raw materials, such as crude oil. However, this diminishing trend reversed towards the end of the year. Although this slight upwards movement will persist in the coming months with some figures close to the 4 % mark and peaking in February, we can assume that the fall in consumer price inflation will continue in 2005 to just below 3 % on average, which will be attributable in particular to favourable developments in the second six months. The strength of the tolar exchange rate will make a not insignificant contribution to these changes in inflation. Upon entry into the European exchange rate mechanism (ERM2) at the end of June 2004, a parity was set for the Slovenian currency to the euro (239.640 SIT for 1 euro). While the tolar was steadily devalued up until that point in order to keep the exchange rate stable in real terms, the tolar has since then remained unchanged against the euro in nominal terms.

No problems with the current account

Apart from the positive impact on the development of inflation, the change in exchange rate policy represents a challenge for the Slovenian export sector. The real appreciation against the euro could reduce the competitiveness of the Slovenian economy. However, figures available so far do not suggest this. Although after the first ten months of 2004 the trade deficit totalling 500 mn euros was clearly above the comparable figure for 2003 (–329.5 mn euros), this was caused primarily by the high growth in imports, while export growth on average for January to October accelerated into double figures. The surplus in services turned the current account deficit into a surplus again by around 50 mn euros. As in recent years, towards the end of 2004 the balance of services is not likely to be able to compensate fully for the trade deficit owing to lower foreign exchange revenue from tourism (seasonal fluctuations), and thus we assume that the current account deficit for the whole of 2004 will be in the region of 0.3 % of GDP.

Gross foreign debt increased to around 58 % of GDP by year-end 2004. Debt servicing, which in the next two years will again amount to around 12 % of goods and service exports, does not, however, pose any difficulties for the Slovenian economy. And with an AA- from Standard & Poor's alongside an Aa3 from Moody's, Slovenia has by far the best rating of all the new EU member states. ■

Outlook

In 2004 the Slovenian economy proved to be surprisingly lively. Powerful growth rates of 4 % will also be symptomatic of 2005/2006. The falling inflationary trend will continue, even though it may slow down thanks to persistently strong domestic demand. On the other hand it will be supported by the stable exchange rate of the tolar against the euro in ERM 2. But the slight real appreciation that is anticipated will barely affect foreign trade since this will be compensated for by progress in productivity. Over the forecast period then we still only expect a negligible current account deficit. Adopting the euro at the beginning of 2007 is still within grasp provided the budget remains essentially in order, although the 2004 elections ensured that the deficit rose above the 2 % mark for the first time in two years, in spite of strong economic growth. Structural changes and reforms, for example in the field of health care, have to be priorities of the new government, in order to induce a sustained reduction in the budget deficit. The coming months will reveal whether the new government has followed up the promised reforms with action, helping to polish up the somewhat dusty image of Slovenia, whereby the stance regarding privatisations and towards foreign investors will be the most important gauge.

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Area: 603,700 sq. km
Population: 47.69 mn
President:
Viktor Yushchenko (elected)
Prime Minister: to be nominated
GDP (2004): EUR 48.7 bn
GDP per capita (2004): EUR 1,020

Ukraine

Orange transformation

Yushchenko wins

At the runoff or the presidency held on 26 December that was repeated because of electoral fraud, Viktor Yushchenko obtained 52 % of the votes while his opponent, Prime Minister Viktor Yanukovych who was granted leave, collected 44 % of the votes, with the remaining voters either being invalid or reading "against both". Even more important than the fact that Yushchenko won is the manner how he won. The mass movements in Central and Eastern Europe in 1989 created the conditions for the enlargement of the EU towards the east in May 2004. Fifteen years later, at the end of 2004, Europe is again witnessing such a movement, the Ukrainian "orange" revolution. It was facilitated by differences between the power groups in Ukraine, in particular between those in Donezk, backing Viktor Yanukovych, and those in Dnjepropretovsk, with Leonid Kutschma as one of their representatives. Yet it did mobilise broad sections of society, establishing a democratic antipole both to state power and to the economic clans. This will have a sustained impact also on the country's economy.

Not exactly wealthy

Ukraine had substantial difficulties reorganising its economy following the collapse of the Soviet Union and to date has not yet reached the production levels recorded in 1991. Per capita GDP (based on purchasing power) is barely higher than that of China. The number of cars per 1000 inhabitants is just over 100, which is half the ratio in Bulgaria, and looking at the number of computers (PCs) per capita Ukraine is just behind Morocco and has about one-fifth of the numbers recorded for Hungary and Poland. However, since the crisis in 1998 that was triggered by the Russian crisis, Ukraine has turned the corner. The country has stabilised, it is running current account surpluses and is growing fast. Now Ukraine faces a radical change in social and economic cultures, and it is no coincidence that the political conflicts have come to a head just now.

Boom year 2004

Strong foreign demand for metals and high prices enabled exports to expand by 45 % year-on-year in dollar terms in the first three quarters of 2004, alongside an increase in imports of 29 %. Even exports of foodstuffs and chemical products rose sharply. The current account surplus rose from 2.5 billion US dollars (6.7 % of the GDP) in the first three quarters of 2003 to 5.8 billion US dollars (13.8 % of the GDP) in the same period in 2004. The improved financial situation of companies enabled year-on-year growth in real wages of 24 % over the first ten months of 2004, resulting in real growth of 21 % in retail sales. Real GDP grew 12.4 % yoy in the first eleven months of 2004. Companies increased their fixed capital investments by 35 % in the first three quarters of 2004, adjusting for inflation. Although output growth is likely to have declined in December on account of the political events, real GDP growth is likely to have amounted to about 12 % in 2004 as whole.

Budget deficit widens

A significant increase in expenses on social security, wages and defence coupled with only moderate success in collecting value added tax have led to a consolidated budget deficit (of the central government and local authorities) of 1.8 % of GDP in the first ten months of 2004, de-

Ukraine – Selected Indicators

	2001	*2002*	*2003*	*2004*	*2005*	*2006*
Change from previous year in %					*Forecast*	
GDP (real)	9.2	5.2	9.4	12.0	6.0	8.0
Industrial output (real)	14.2	7.0	15.7	13.0	7.5	9.0
Gross fixed capital formation (real)	13.2	6.0	16.0	20.0	5.0	13.0
Consumer prices (yearly average)	12.3	0.8	5.2	8.9	12.0	9.0
Unemployment (yearly average)	11.8	10.1	9.1	7.8	7.5	9.0
Budget balance (in % of GDP)	–1.5	0.2	0.1	–3.0	–4.0	–2.0
in EUR mn						
Merchandise exports	19,075	19,732	20,959	26,750	26,250	28,930
Merchandise imports	18,854	18,982	21,197	25,120	25,770	29,690
Current account	1,565	3,354	2,552	5,640	4,050	2,820
Current account (in % of GDP)	3.7	7.7	5.9	11.6	7.8	4.6
FDI (inflow, net)	858	732	1,257	1,290	1,790	2,520
Gross foreign debt (end of period)	22,799	22,922	21,023	23,430	24,690	28,550
Gross foreign debt (in % of GDP)	53.7	52.4	48.2	48.1	47.8	46.9
Import cover (in months)	1.7	2.4	3.0	2.9	2.9	3.1
Average exchange rate: UAH/EUR	4.8	5.0	6.0	6.6	7.4	7.4
Average exchange rate: UAH/USD	5.4	5.3	5.3	5.3	5.3	5.3

Sources: Bank Austria Creditanstalt Economics Department, National Bank of Ukraine spite strong economic growth. In the same period of the previous year there was a surplus of 1.8 % of GDP. The 2005 budget calls for a central government deficit of 8.8 billion hryvnias or 2.3% of GDP; the general government deficit will probably be somewhat higher. Regardless of what the parliament decides, however, it is the political processes of 2005 which will determine the actual development. New discussions on the budget can be expected from February, where on the one hand there are calls for a balanced budget – also from Yushchenko – but on the other hand there is also a wide range of diverse promises made during the election campaign that have to be addressed.

Are the banks holding up?

The unstable political situation prompted many Ukrainians to withdraw their savings from bank accounts or demand the early repayment of fixed term deposits, foregoing the due interest, and to convert their hryvnias into dollars. President Leonid Kutschma poured oil onto the fire by warning that the Ukrainian financial system would soon collapse like a house of cards if the political situation did not stabilise without delay. The central bank reacted by restricting withdrawals made by private individuals and companies and limiting the acquisition of foreign exchange to 1000 dollars per day. Limits have also been placed on lending. Between October and December the central bank intervened by selling about 2 billion US dollars in order to support the hryvnia, which it wants to keep at a rate of 5.3 to the dollar. By the middle of December foreign exchange reserves had fallen to 9.5 billion US dollars , corresponding to three months of goods and services imports. It is possible that some of the weaker banks will still fall into difficulties, but on the whole the measures taken by the central bank are likely to have been successful.

Meagre FDI

In spite of economic stabilisation and the boom since 2003, Ukraine has received less than 5 billion euros in foreign direct investment over the last five years (from 2000 to 2004). This is less than Bulgaria received, which has six times fewer inhabitants, and not much more than one sixth of the investment that went into Poland, notwithstanding the fact that Ukraine has a steel industry of international significance, great agriculture potential, and a automotive industry which accounts for almost 6 % of the value added generated by the industrial sector. The main Ukrainian car manufacturer, AvtoZAZ, produced almost 70,000 cars in 2003, while this figure is likely to have risen to 100,000 in 2004.

Implications for the EU

Despite a population of almost 48 million Ukraine currently plays a relatively small role for the EU economy. German imports from Ukraine for example totalled 742 million euros in 2003, only one-tenth of the import volume from Slovakia and one-twentieth of goods imported from Poland (Austria: 272 million euro, corresponding to one-sixth of imports from Slovakia and one-quarter of imports from Poland). To a large extent the moderate significance of Ukraine and in particular the low level of foreign direct investment have been due to the lack of institutional reforms and above all their implementation. But economic relations between Ukraine and the EU are now likely to intensify. The EU will have to modify its policy vis-à-vis Ukraine and indeed has already begun to do so through the important role that Xavier Solana played in mediating between the disputing parties. After all, no less than 40 % of Ukraine's exports flow into the EU-25. Three of the new EU member states share their borders with Ukraine, and once Romania joins this number will rise to four. Ukraine is not offered sufficient prospects with the "European Neighbourhood Policy". In order to stabilise the region from a political and economic point of view, the EU cannot afford to keep the door closed for Ukraine.

Strengthening relations with Ukraine will intensify certain questions that are already on the discussion table: at current exchange rates, wage costs in Ukraine amount to approximately one-eighth of those in Poland, one-quarter of those in Slovakia and less than half of the corresponding costs in Romania. What should one do with a cheap labour country on one's doorstep? This is also a question asked by the new EU member states. And again, the only answer can be to accelerate the process of structural change in one's own country and cushion the adverse social impact of this process, instead of fighting futile defensive battles. Small and medium-sized enterprises in particular are in any event likely to find it much easier to outsource production to Ukraine than to China. ■

Outlook

The change in power which resulted not only in Viktor Yushchenko becoming president but also in new majority structures in the parliament will accelerate the reform process in Ukraine and point the way towards the EU. This will impact positively on the flow of direct investment and on the integration in the European division of labour, but does also imply certain risks. Ukraine has thus far been treated as a friendly foreign country by Russia and accordingly pays a very favourable price for gas supplies. In the first six months of 2004 for example this totalled 1,363 roubles per thousand cubic metres, while for Western Europe it was 3,722 roubles. Gas imports account for 14 % of all Ukrainian imports, which exceeds 4 billion US dollars. Any drastic price rise would have a serious effect on Ukraine. Problems could also be encountered because the major mineral extraction and metallurgy companies are concentrated in the eastern part of the country. Although plans to win autonomy for the eastern region are not likely to be successful, any political resistance from the metallurgy corporations and coal mines could complicate the situation and delay reforms. Yet what is more probable is that Ukraine will now relatively quickly become a more open society, with relatively transparent market economic processes, although temporary "real political" compromises with diverse groups and the emergence of differences within the "orange movement" cannot be ruled out.

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Area: 28,748 sq. km
Population: 3.2 mn
President: Alfred Moisiu
Prime minister: Fatos Nano
GDP (2004): EUR 6.5 bn
Per capita GDP (2004): EUR 2,050

Albania

Stopping train into a better future

Political situation

After a small government reshuffle in October 2004, comprising a change in positions of some deputy ministers, the Socialist Prime Minister Nano precluded further changes in the government till the parliamentary elections scheduled for summer 2005. Already since autumn, Albania has been under the spell of these elections, for a new election law, which will permit just elections in conformity with international democratic standards, is still being negotiated by the central election commission, with representatives of the opposition participating in these negotiations. Such an improved legal basis is considered by the EU as a precondition for signing a Stability and Association Agreement.

Economic situation

After a somewhat weaker first quarter, 2004 was characterised by very strong economic growth of about 6 %. In particular construction industry and, favoured by stable climatic conditions, also agriculture, which contributes approximately 1/4 to the economic performance of the country, were important pillars of growth of Europe's economic laggard. Strong economic growth contributed to an improvement of the situation in the labour market and supported the observance of the budget estimate, which in line with the current IMF programme of 2004 is expected to amount to just under 5 % of GDP. This fiscal policy according to plan also constituted an important pillar for attaining the inflation target set by the central bank. At 2.9 % on average, the inflation rate was almost exactly in the middle of the target range of 2 % to 4 %, although increased prices of raw materials, in particular crude oil, also burdened the development of inflation in Albania. Their weight in the consumer price index is, however, markedly lower than in the western industrialised countries, and in addition the appreciation of the lek against the US dollar had a dampening effect. Especially in the third quarter, inflows of foreign exchange from tourism and from Albanians living abroad resulted in an upward exchange rate pressure, which the central bank also tried to counter by again lowering interest rates. Since the beginning of 2004, the basic interest rate has been reduced to 5.25 % annually in five steps altogether. The central bank hopes to also boost financings through loans by this measure, particularly since the banking sector has gained in stability and confidence in the meantime as a result of the sale of the Albanian Savings Bank to a foreign investor.

The slowly improving macroeconomic picture of the country continues to be dimmed by the high external imbalance. The current account deficit, which at almost 200 mn euro after the first half of the year, slightly exceeded the comparable figure of the same period of last year, is expected to amount to nearly 440 mn euro in 2004 as a whole, corresponding to 6.8 % of GDP. ■

Albania – Selected Indicators

	2001	2002	2003	2004	2005	2006
Change from previous year in %					*Forecast*	
GDP (real)	7.6	4.7	6.0	6.0	6.5	6.0
Industrial output (real)	6.5	2.1	3.0	3.5	4.0	3.0
Gross fixed capital formation (real)	–	–	–	–	–	–
Consumer prices (yearly average)	3.1	5.2	2.4	2.9	3.0	3.0
Unemployment (yearly average)	15.5	13.3	15.2	14.8	14.5	14.0
Budget balance (in % of GDP)	–8.3	–6.0	–4.1	–5.0	–4.6	–4.3
in EUR mn						
Merchandise exports	340	349	390	480	530	610
Merchandise imports	1,473	1,570	1,570	1,730	1,870	2,050
Current account	–323	–431	–360	–440	–500	–540
Current account (in % of GDP)	–6.8	–8.4	–6.6	–6.8	–7.1	–7.2
FDI (inflow, net)	228	143	160	200	270	220
Gross foreign debt (end of period)	1,337	1,250	1,240	1,370	1,470	1,510
Gross foreign debt (in % of GDP)	28.2	24.3	23.0	21.0	20.8	20.2
Import cover (in months)	5.1	5.0	4.8	4.3	4.3	4.2
Average exchange rate: ALL/EUR	128.5	132.4	137.6	127.6	130.0	135.0
Average exchange rate: ALL/USD	143.6	139.9	121.8	103.0	93.3	97.1

Sources: Bank Austria Creditanstalt Economics Department, IMF, Instat, BOA

Outlook

Irrespective of the forthcoming parliamentary elections, Albania will remain one of the markets with the most dynamic growth in the region Thanks to a consistent fiscal policy, which provides for a slightly reduction of the budget deficit to 4.6 % of GDP, inflation will be within the target range set by the central bank. The current account gap is likely to even widen to more than 7 % of GDP in the next two years. If the planned privatisation projects, e. g. the Albanian telecom, will be put into practice, this should result in a record FDI inflow, which will be able to cover a large part of this financing gap. The FDI inflow could in addition give a fresh impetus to the delayed restructuring of the economy.

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Area: 45,227 sq. km
Population: 1.4 mn
President: Arnold Rüütel
Prime Minister: Juhan Parts
GDP (2004): EUR 8.8 bn
Per capita GDP (2004): EUR 6,520

Estonia

Old goverment, new fortunes?

Political situation

The three-party centre-right coalition of Prime Minister Juhan Parts, which is suffering a serious loss in popularity, has passed its next test with the approval of the 2005 budget. The impending threat of a collapse of the government coalition has for the moment therefore been averted. In view of the government's current low popularity, the 2005 budget is strongly characterised by efforts to please the electorate. Besides a balanced budget it calls for a reduction of income and corporate tax rates from 26 % to 24 %, and an increase in the tax-free allowance from 1,400 to 1,700 Estonian kroons. The consequent loss in revenue is to be offset by an increase in excise taxes on alcohol, tobacco and fuels. On the expenditure side, the budget focuses on the pension system and measures to stimulate the labour market.

Economic situation

Estonia's economy accelerated slightly with GDP growing by a real 6.1 % in the third quarter, compared with both the growth rates of the previous quarter (+5.9 %) and the corresponding quarter of the previous year (+5.2 %). Growth continues to be driven by robust domestic demand, now increasingly supported by exports which are benefiting from the upturn in the international telecom industry. The preliminary data point to sustained strong export activity in the final quarter of 2004, so that after a lean period of four years net exports will probably again make a positive contribution to GDP growth in 2004. A more balanced composition of growth components will in 2004 consequently result in an acceleration of economic growth to 6.3 % (2003: +5.1 %). The strong growth in exports is also supporting the industrial sector, which together with the booming construction industry, provides an important impetus for employment. The registered unemployment rate fell to 4 % at the end of September 2004, down from 4.9 % in the corresponding period of the previous year.

The current account situation remains strained despite the strong demand for exports, and the current account deficit will even rise slightly to 13.4 % of GDP in 2004 (2003: 13.2 %). This is attributable not only to the massive deterioration of the balance of trade, but also to a widening of the deficit of the income balance on account of higher dividend payments (repatriated profits). In light of an increase in EU transfers, the deficit was, however, dampened by a higher surplus from current transfer payments, and by a marked rise in the surplus of the balance of services following higher revenues from tourism and transportation. Although the prospects for the export sector remain favourable, and despite a gradual weakening of private consumption as a result of slower real wage growth and a subsiding of the credit boom, the current account deficit in 2006 will probably still persist at just over 10 % of GDP. ■

Estonia – Selected Indicators

	2001	2002	2003	2004	2005	2006
Change from previous year in %					*Forecast*	
GDP (real)	6.4	7.2	5.1	6.3	6.0	5.8
Industrial output (real)	9.0	8.3	9.9	8.3	8.8	8.0
Gross fixed capital formation (real)	13.0	17.2	5.4	7.5	8.3	9.0
Consumer prices (yearly average)	5.8	3.6	1.3	3.0	3.5	2.5
Unemployment (yearly average)	12.6	10.3	10.0	9.8	9.5	9.2
Budget balance (in % of GDP)	0.3	1.0	2.4	0.5	0.3	0.1
in EUR mn						
Merchandise exports	3,750	3,728	4,060	4,790	5,430	6,070
Merchandise imports	4,630	4,878	5,460	6,420	7,250	8,080
Current account	–376	–759	–1,060	–1,180	–1,120	–1,090
Current account (in % of GDP)	–5.6	–10.2	–13.2	–13.4	–11.6	–10.4
FDI (inflow, net)	377	167	670	420	480	450
Gross foreign debt (end of period)	3,707	4,490	5,660	7,030	8,310	9,580
Gross foreign debt (in % of GDP)	55.6	60.1	70.4	79.8	86.0	91.5
Import cover (in months)	1.9	1.9	2.0	2.0	2.0	2.0
Average exchange rate: EEK/EUR	15.65	15.65	15.65	15.65	15.65	15.65
Average exchange rate: EEK/USD	17.48	16.60	13.81	12.60	11.24	11.26

Sources: Bank Austria Creditanstalt Economics Department, Eesti Pank, ESA

Outlook

The government's work is likely to be accompanied by strained relations within the coalition. A change of government is therefore not to be ruled out, although this is unlikely to affect the country's economic policy whose main objective is Estonia's participation in the euro zone in 2007. Estonia's economy will continue to grow dynamically at an average rate of some 6 % in the years 2004–2006. The current account situation remains tense however with negative consequences for the country's indebtedness. Against a background of good growth prospects, a disciplined fiscal policy and the adoption of the euro in 2007, Standard&Poors upgraded Estonia's long-term foreign currency rating from A- to A.

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Sándor Gardó

Area: 64,589 sq. km
Population: 2.3 mn
President: Vaira Vike-Freiberga
Prime Minister: Aigars Kalvitis
GDP (2004): EUR 10.8 bn
Per capita GDP (2004): EUR 4,710

Latvia

New government, new fortunes?

Political situation

The excitement over the designated EU Commissioner Udre had hardly subsided when the government of Prime Minister Indulis Emsis collapsed following the rejection of the 2005 budget. The designated Prime Minister Aigars Kalvitis introduced his cabinet on 2nd December. The four-party centre-right coalition, comprising the People's Party (20 seats), the New Era (24), the Greens/Farmers Union (12) and the First Party (14), has 70 seats altogether which at present give it a comfortable majority in the Saeima. The government's new strength is also its weakness. Its broad basis ensures that the government will retain the necessary majority in parliament in the event that one of the coalition parties (with the exception of the New Era) should withdraw. At the same time, however, it will probably be very difficult for all the coalition partners to find a consensus, something which could make the Kalvitis government a short-lived phenomenon similar to the 12 previous governments since Latvia's independence in 1991.

Economic situation

With real GDP growth of 9,1 % the Latvian economy recorded strong growth also in the third quarter, resulting in an average growth rate of 8,5 % in the first nine months of 2004. The overall picture has hardly changed. Growth continues to be driven by robust domestic demand, but mainly by private consumption which is benefiting from the improvement in employment and the credit boom. This in turn has a negative impact on the balance of trade and the current account. The current account deficit again widened significantly to 10.4 % of GDP in the third quarter of 2004 from "only" 9.3 % of GDP in the corresponding period of the previous year, after already doubling in the first six months.

Moreover, inflation has become the Achilles heel of the Latvian economy. In the first half of the year it was mostly one-off effects such as price and tax adjustments in connection with EU accession which were responsible for the inflationary pressure. In the second half, however, inflation seems to be driven by the high prices for raw materials, the predominant credit boom and the related strong domestic demand. The danger of an overheating of the economy prompted the Bank of Latvia in March to raise the reference rate from 3 % to 3.5 %, and to increase the minimum reserve ratio from 3 % to 4 % in July. In the absence of any tangible effect, it raised the reference rate by a further 50 basis points to 4 % in November. Furthermore, the basis for computing the minimum reserves to be maintained with the central bank was expanded to include the commitments of Latvian banks towards foreign commercial and central banks. ■

Latvia – Selected Indicators

	2001	2002	2003	2004	2005	2006
Change from previous year in %					*Forecast*	
GDP (real)	8.0	6.4	7.5	8.7	7.0	6.5
Industrial output (real)	6.9	5.8	6.5	6.2	6.4	5.9
Gross fixed capital formation (real)	11.4	13.0	7.4	14.0	12.5	11.5
Consumer prices (yearly average)	2.5	1.9	2.9	6.2	4.7	3.1
Unemployment (yearly average)	13.1	12.0	10.6	10.0	9.5	9.0
Budget balance (in % of GDP)	–2.0	–2.3	–1.6	–1.4	–2.0	–2.5
in EUR mn						
Merchandise exports	2,502	2,693	2,810	3,260	3,740	4,300
Merchandise imports	3,993	4,255	4,580	5,340	6,010	6,820
Current account	–699	–653	–810	–1,340	–1,250	–1,190
Current account (in % of GDP)	–7.6	–6.7	–8.2	–12.3	–10.4	–8.9
FDI (inflow, net)	126	265	235	445	367	371
Gross foreign debt (end of period)	6,321	7,187	7,850	9,350	10,710	12,300
Gross foreign debt (in % of GDP)	68.9	73.6	80.0	86.3	89.3	92.4
Import cover (in months)	3.3	3.1	2.7	3.0	3.0	3.0
Average exchange rate: LVL/EUR	0.56	0.58	0.64	0.67	0.68	0.67
Average exchange rate: LVL/USD	0.63	0.62	0.57	0.54	0.49	0.49

Sources: Bank Austria Creditanstalt Economics Department, Latvijas Bankas, Latvijas Statistika

Outlook

While the frequent changes in government increase the political risk, no significant changes in economic policy are expected. The economy will grow at a robust rate of 8.7 % in 2004, and economic growth will weaken only slightly in 2005 and 2006. A more restrictive monetary policy will gradually ease the inflationary pressure whilst also limiting the current account deficit. The euro replaced the special drawing rights of the IMF as key currency as of 1st January 2005. Latvia will moreover soon join the ERM II, within which Latvia's currency will move within a band of +/–1 % against the central parity of 0.702804 LVL to 1 EUR, until it adopts the euro (probably on 1 January 2008).

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Area: 65,301 sq. km
Population: 3.5 mn
President: Valdas Adamkus
Prime Minister: Algirdas Brazauskas
GDP (2004): EUR 17.5 bn
Per capita GDP (2004): EUR 5,105

Lithuania

New government, old fortunes?

Political situation

After the second round of the parliamentary elections President Valdas Adamkus again entrusted Prime Minister Algirdas Brazauskas with the formation of a new government. Following the outcome of the negotiations for a government coalition, the former-new prime minister now leads a centre-left coalition comprising the Social Democrats and Social Liberals, which made up the government in the preceding legislative period, the Labour Party and the Farmers Party. The key ministries such as finance, labour and social affairs, foreign policy, transport, defence and education remain in the hands of the former ruling parties. The Labour Party has been given the Ministry for Economic Affairs (with party leader Viktor Uspaskich as Economics Minister), the Ministry for Home Affairs, as well as the ministries of Culture and Health. The Ministry of Agriculture was assigned to the Farmers Party. The new government coalition seems to be a successful mix of old and new components. The broad base, however, has a conflict potential which should not be underestimated.

Economic situation

In the third quarter of 2004 Lithuania's economic growth slowed to 5.8 %, after 7.3 % in the previous quarter and 9.3 % in the same quarter of the preceding year. The slowdown is explained by a subsiding of the effects of accelerated purchases in connection with EU accession which characterised the first six months, and by the high base effect. Industry, wholesale and retail trade, and the hotel and restaurant sector remained the main components of economic growth. A significant impetus was however also provided by the construction industry which is experiencing a boom on account of state-assisted real estate loans and an increase in EU transfers.

The base effect will also remain predominant in the final quarter of 2004 and lead to a further slowdown in economic growth. We expect economic growth to reach 6.5 % in 2004, after +9.7 % in 2003. Growth is likely to stagnate at a high level in 2005. The dampening effect of net exports will prevent an acceleration of economic growth, despite continued robust domestic demand. This is because the first reactor of the Ignalina power plant was shut down at the end of 2004, which will greatly reduce electricity exports and in turn increase the need for imports. This development will not help to significantly ease the already tense current account situation. The balance of trade and income balance are likely to raise the current account deficit to 8.7 % of GDP already in 2004 (6.9 % of GDP in 2003), with negative consequences for Lithuania's indebtedness notwithstanding the high FDI inflows in 2004. ■

Lithuania – Selected Indicators

	2001	2002	2003	2004	2005	2006
Change from previous year in %					*Forecast*	
GDP (real)	6.4	6.8	9.7	6.5	6.5	6.0
Industrial output (real)	16.0	3.1	16.1	10.5	8.3	8.7
Gross fixed capital formation (real)	15.0	12.4	11.4	13.5	11.5	10.5
Consumer prices (yearly average)	1.3	0.3	–1.2	1.2	2.8	2.4
Unemployment (yearly average)	17.4	13.8	12.4	11.5	10.5	10.0
Budget balance (in % of GDP)	–2.1	–1.4	–1.7	–2.6	–2.4	2.0
in EUR mn						
Merchandise exports	5,456	6,375	6,773	7,500	8,110	8,980
Merchandise imports	6,693	7,785	8,262	9,210	10,280	11,440
Current account	–640	–773	–1,116	–1,520	–1,590	1,560
Current account (in % of GDP)	–4.7	–5.2	–6.9	–8.7	–8.3	–7.5
FDI (inflow, net)	490	754	126	620	670	700
Gross foreign debt (end of period)	5,879	5,945	6,905	7,820	8,980	9,990
Gross foreign debt (in % of GDP)	43.6	39.7	42.4	44.6	46.8	47.9
Import cover (in months)	3.0	3.2	3.5	3.3	3.2	3.2
Average exchange rate: LTL/EUR	3.58	3.45	3.45	3.45	3.45	3.45
Average exchange rate: LTL/USD	4.00	3.65	3.05	2.78	2.48	2.48

Sources: Bank Austria Creditanstalt Economics Department, Lietuvos Bankas, Statistics Lithuania

Outlook

The constitution of the new government ensures continuity, and it is expected that the government will continue to pursue the previous stability-oriented economic policy. Lithuania will fulfil all Maastricht criteria also in 2004 and consequently remains on track for the adoption of the euro in 2007. With an average inflation rate of 1.2 % in 2004, the country is one of the EU25 countries with the greatest price stability. Public indebtedness, at 20 % of GDP, is only about one-third of the maximum permitted pursuant to the EU requirements. The 2005 budget calls for a deficit of 2.75 % of GDP. In the first quarter of 2005 Lithuania will launch an EUR 500–600 million eurobond issue to finance the deficit.

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Area: 25,731 sq. km.
Population: 2 mn
President: Branko Crvenkovski
Prime Minister: Vlado Buckovski
GDP (2004): EUR 4.1 bn
Per capita GDP (2004): EUR 2,020

Macedonia

Economy held captive by politics

Political situation

Prime Minister Kostov has resigned after having been in office for less than six months. The independent politician, whose policy was even confirmed recently by the aborted referendum against the decentralisation law passed in August, which provides for a repartition of Macedonia into 80 administrative districts and a strengthening of minority rights, gave the ethnocentric client policy of the small coalition partner, the Albanian Democratic Union for Integration (DUI), which, he said, prevented the implementation of necessary reforms, as the reason for his resignation. President Crvenkovski entrusted Defence Minister Vlado Buckovski with the formation of a new government, which again comprises the Social Democrats and the DUI. The renewed cooperation will result in even more concessions being made by the Social Democrats to the DUI. This is unlikely to help Macedonia on its path of economic reform. In spite of poor results for both parties in recent polls, early elections in March together with local elections are not completely improbable.

Economic situation

After a bad start into the current year, i.e. a decline in GDP of 1.7 % in the first half of the year, Macedonia's economy began to recover only slightly in the further course of the year. This development is reflected in industrial output, which still shows a decrease of 16 % in the first ten months compared with the same period of last year. According to our estimate, GDP growth amounted to merely 1.5 % in 2004. The restrictive fiscal and monetary policies were an essential cause of this restrained growth. In 2004, the government implemented a budget projecting a central government deficit of about 1 % of GDP and an overall government deficit of slightly over 2 % of GDP. Due to weak economic growth, which made itself felt in a loss of tax revenues, additional cuts in expenditure had to be decided for that purpose in autumn. In agreement with the IMF, with which a new stand-by agreement is to be concluded at the beginning of 2005, this cautious budget policy with an estimated deficit of 1.1 % of GDP in the central government budget and 2.3 % of GDP in the overall government budget will be continued this year as well. The central bank, which raised the 28 days repo rate in three steps by a total of 2 percentage points to now 10 % annually already in the second half of 2004, also wants to maintain its cautious policy. Moreover, the continued de facto pegging of the denar to the euro will be essential for further checking inflation. ■

FYR Macedonia – Selected Indicators

	2001	2002	2003	2004	2005	2006
Change from previous year in %					*Forecast*	
GDP (real)	–4.5	0.9	3.4	1.5	3.0	4.0
Industrial output (real)	–3.1	–5.3	4.7	–12.0	6.0	4.0
Gross fixed capital formation (real)	–29.9	10.0	7.5	5.0	–	–
Consumer prices (yearly average)	5.5	1.8	1.2	–0.3	1.2	2.0
Unemployment (yearly average)	30.9	31.9	36.7	35.0	33.0	32.0
Budget balance (in % of GDP)	–7.2	–5.6	–1.6	–2.1	–2.4	–2.0
in EUR mn						
Merchandise exports	1,290	1,176	1,200	1,290	1,300	1,400
Merchandise imports	1,877	2,026	1,952	2,100	2,200	2,400
Current account	–272	–378	–135	–250	–260	–290
Current account (in % of GDP)	–7.1	–9.5	–3.3	–6.1	–6.0	–6.3
FDI (inflow. net)	492	82	83	120	80	120
Gross foreign debt (end of period)	1,653	1,704	1,604	1,600	1,700	1,900
Gross foreign debt (in % of GDP)	43.1	42.8	38.9	38.9	38.9	40.7
Import cover (in months)	4.8	4.0	4.3	3.8	4.0	4.0
Average exchange rate: MKD/EUR	60.9	61.0	61.3	62.0	61.5	61.5
Average exchange rate: MKD/USD	68.0	64.7	54.3	49.9	44.2	44.3

Sources: Bank Austria Creditanstalt Economics Department, IMF, NBRM

Outlook

After the weak start at the beginning of the year, the economy only achieved a very moderate growth in 2004, and GDP growth will remain restrained also in the medium term due to structural problems. A new programme of action in cooperation with the IMF and the World Bank focuses on combating these structural problems. Besides politics, which constitutes a considerable risk factor for a favourable economic development of the country, the restrictive fiscal and monetary policies will also limit growth for the time being. In view of a current account deficit of about 6% of GDP there is, however, hardly any leeway in this respect. The slow approach to the EU promises support with regard to structural reforms.

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Area: 17 million sq. km
Population: 144 mn
President: Vladimir Putin
Prime Minister: Mikhail Fradkov
GDP (2004): EUR 468.4 bn
Per capita GDP (2004): EUR 3,260

Russia

Energy games

Political reform

In December, parliament adopted President Putin's bills for reforming the political power structure: 1) The appointment of the governors of the regions by the president instead of by regional elections, but with the regional parliaments having to give their consent. Should they reject the candidates of the president three times in a row, he can, however, dissolve them. 2) The abolition of the regions' direct mandates in the Duma and elections solely from party lists. These steps mean a further strengthening of the central authority with regard to both the regions and powerful groups which have gained influence in the Duma by supporting regional MPs.

Mysterious shareholders

The further increase in the power of the Kremlin is accompanied by a change in the ownership structures of major companies. In the end, the state-owned Rosneft group proved to be the party behind the unknown "Baikal Finance", which has purchased 76.8 % of the shares of Yuganskneftegaz, the Yukos subsidiary put up for compulsory auction, for 9.35 bn US dollar. It is obviously a complicated procedure, as a result of which Yuganskneftegaz, which accounts for 60 % of the production of Yukos, goes to Gazprom after all. The government plans to exchange its shares in Rosneft for Gazprom shares, to merge Rosneft with Gazprom and thus become majority owner of Gazprom at the same time.

In the second most important sector of the Russian economy, the metal industry, a mysterious "UFGIS Structured Holdings" made its appearance recently. It bought from the state its 17.8 % share in the largest Russian steel producer NMK for 790 mn US dollar in a three-minute auction. Only hours before, another important interested party, the steel consortium Mechel, had sold its 17 % share to a group closely associated with the management. According to media reports, the management now probably controls more than 90 % of the company, since UFGIS is also closely connected with it.

An excellent 2004

The Russian economy again experienced a boom in 2004. In the first 3 quarters of 2004, GDP increased by 7.0 % in real terms compared with the previous year. In 2004 as a whole, GDP growth has likely amounted to 6.8 %. The current account surplus rose from 27.1 bn US dollar in the first three quarters of 2003 to 35.9 bn US dollar in the same period of 2004 and probably amounted to 8.4 % of GDP in 2004 as a whole. The budget surplus (of the general government) has probably increased to 3 % of GDP in 2004. Russia is performing so well that it plans to repay prematurely about 10 bn US dollar annually of its external debt to public creditors from 2005 to 2007. ■

Russia – Selected Indicators

	2001	2002	2003	2004	2005	2006
Change from previous year in %					*Forecast*	
GDP (real)	5.1	4.7	7.3	6.8	6.0	6.3
Industrial output (real)	4.9	3.7	7.0	8.6	4.5	4.5
Gross fixed capital formation (real)	11.6	3.0	12.9	10.5	6.0	8.6
Consumer prices (yearly average)	21.5	15.8	13.6	10.8	13.6	14.2
Unemployment (yearly average)	9.0	8.0	8.4	7.8	7.9	8.2
Budget balance (in % of GDP)	3.9	1.0	1.4	3.0	1.5	1.5
in EUR mn						
Merchandise exports	113,410	113,413	120,012	137,870	141,990	154,900
Merchandise imports	60,005	64,439	66,603	75,130	85,470	99,800
Current account	39,017	30,775	31,701	40,790	32,490	33,800
Current account (in % of GDP)	11.3	8.4	8.3	8.4	6.2	5.3
FDI (inflow, net)	3,423	3,866	5,243	8,180	5,220	6,200
Gross foreign debt (end of period)	168,304	161,927	160,777	164,860	172,230	179,600
Gross foreign debt (in % of GDP)	48.7	44.3	42.1	34.1	32.8	28.3
Import cover (in months)	5.4	6.3	9.0	10.5	10.1	8.9
Average exchange rate: RUB/EUR	26.2	29.7	34.8	34.7	37.6	36.1
Average exchange rate: RUB/USD	29.2	31.4	30.7	27.9	27.0	26.0

Sources: Bank Austria Creditanstalt Economics Department, Federal State Statistics Service, CBR

Outlook

In spite of the successes, discussions have begun in Russia on whether a doubling of GDP can be achieved by 2010, as desired by President Putin. The merger of Rosneft and Gazprom will result in a huge state-controlled energy empire, a powerful instrument to influence the domestic economy by selectively subsidising energy prices and providing infrastructure, but also a foreign policy instrument not to be underestimated, in particular with regard to the countries of the former Soviet Union. It remains to be seen whether this concentration will also contribute to the efficiency of the Russian economy. A failure of the energy policy constitutes the main risk for Russia in the long term.